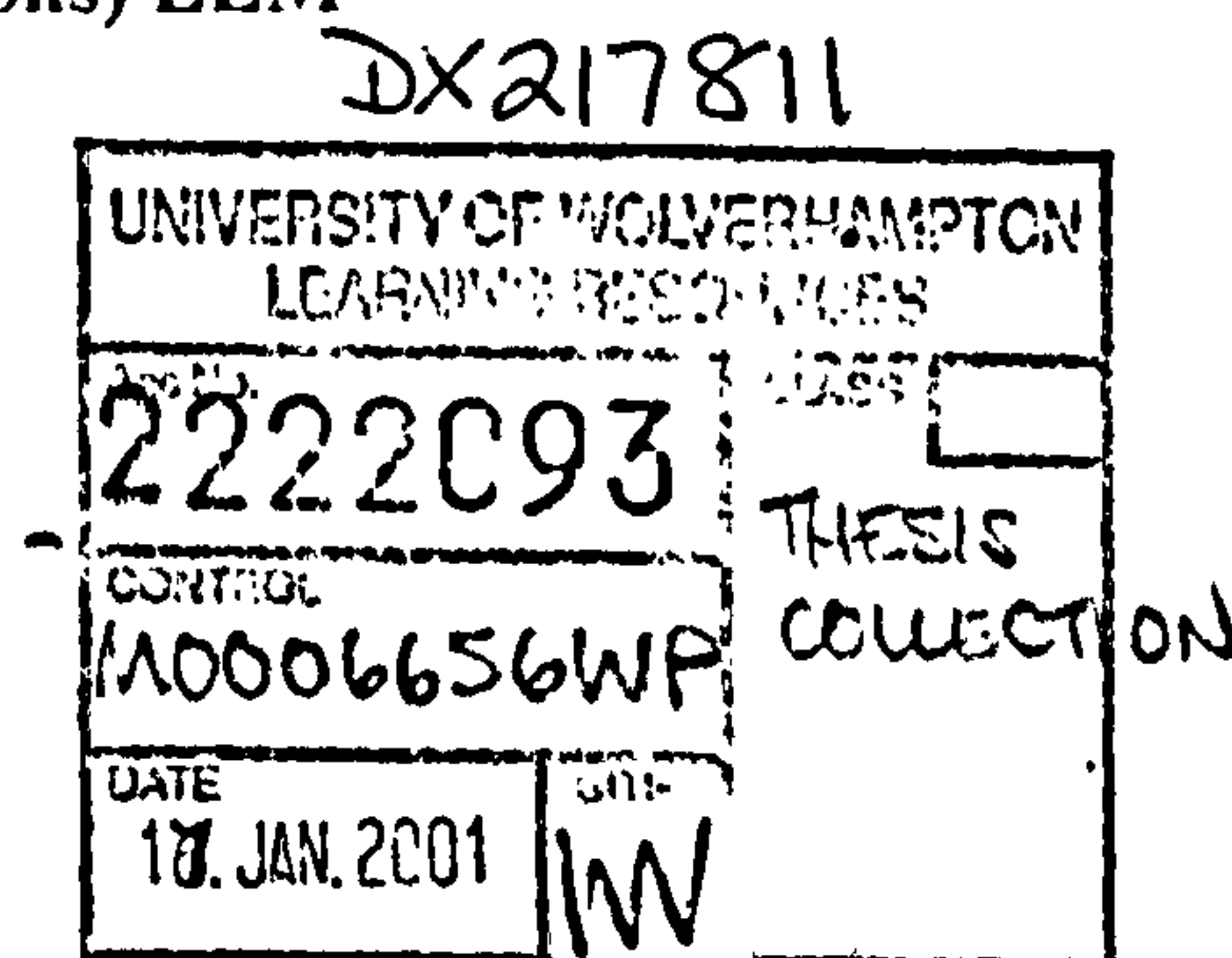


**INSIDER DEALING AND MARKET MANIPULATION:
A COMPARATIVE ANALYSIS OF REGULATORY ENFORCEMENT IN THE
UNITED KINGDOM AND UNITED STATES**

PAUL A. FRYER LLB (Hons) LLM



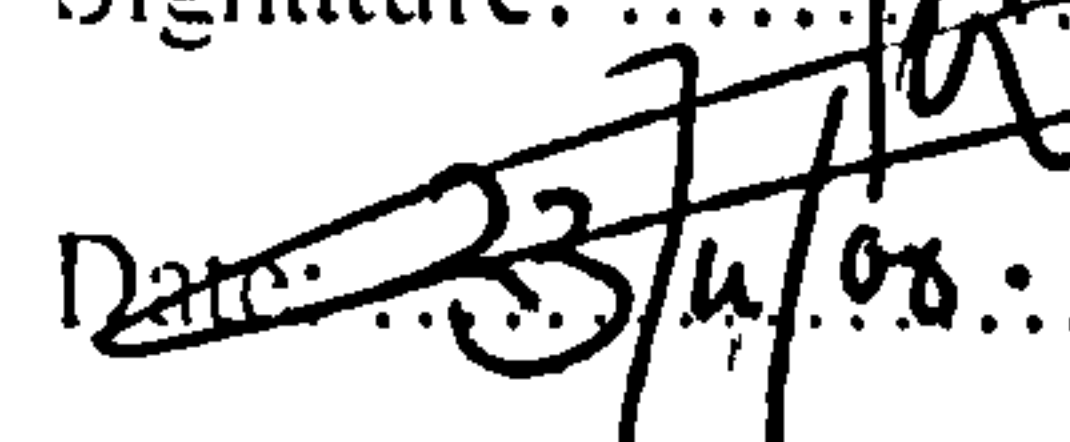
A thesis submitted in fulfillment of the requirements of the University of Wolverhampton
for the degree of Doctor of Philosophy

February 2000

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Abstract

This purpose of this research is to examine the means adopted by the United States and the United Kingdom in combating the main two types of fraud that interfere with financial market trading. These are namely insider dealing or insider trading depending on the jurisdiction that is examined and market manipulation. Both these jurisdictions are examined in relation to the ways each uses differing methods of regulatory enforcement mechanisms to control these types of market fraud.

Acknowledgments

I would like to thank the following individuals who without their help I would not be able to complete this work. First, I would like to thank both Professor Barry Rider and Dalvinder Singh for all their help and constructive criticism. I would also like to thank my wife Sue for all her help. Lastly, I would like to thank Dr Andrew Haynes, who without his help and support this project would not have been started and completed.

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COMMON ABBREVIATIONS*

<i>CA</i>	<i>Companies Act 1989</i>
<i>CJA</i>	<i>Criminal Justice Act 1993</i>
CPS	Crown Prosecution Service
DTI	Department of Trade & Industry
<i>FSA</i>	Financial Services Authourity
<i>FSA '86</i>	<i>Financial Services Act 1986</i>
FSD	Financial Services Division of the Departmant of Trade & Industry
FST	Financial Services Tribunal
IDG	Insider Dealing Grop of the Stock Exchange
MOU	Memorandum of Understanding
OTC	Over the Counter Market
PFI	<i>Prevention of Fraud (Investments) Act 1958</i>
<i>SA</i>	<i>Securities Act 1933</i> (United States)
<i>SEA</i>	<i>Securities Exchange Act 1934</i> (United States)
SEC	Securities and Exchange Commission
SFA	Securities and Futures Authority
SFO	Serious Fraud Office
SIB	Securities Investment Board
SRO	Self Regulatory Organisations

* *This table seeks to represent the most common forms of abbevation used in this thesis. Others are also used but to a lesser extent. Consequently these abbreviations are defined in the chapter(s) in which they are used.*

Section One

The purpose of this thesis is to examine the appropriateness of the procedural and substantive issues that relate to insider dealing and market manipulation. In order to achieve this aim the use of American law and its legal system have been analysed. The reasons for choosing this jurisdiction will become apparent upon the reading of this research. For the sake of clarification the thesis is divided into three broad categories, each of which incorporates a number of chapters. Thus, chapters that fall under section one (chapters one and two) examine the theoretical and philosophical aspects that underpin this work. Section two (chapters three and four) examines the substantive issues relating to these forms of market abuse. Lastly, section three (chapters five, six and seven) examines the theoretical and procedural aspects related to detecting, investigating and prosecuting insider dealing and market manipulation and the problems associated with each facet.

While chapter one has been used to set the scene, by identifying those themes that will be examined in more detail in subsequent chapters, chapter two has been used to identify the theoretical and philosophical miens of market regulation common to both the United Kingdom's and United States' financial markets. This chapter is also used to explore the antithetical arguments that specifically relate to the issue of whether insider dealing and market manipulation should be regulated or not.

Introduction

When this research project into insider dealing and market manipulation in the United Kingdom commenced five years ago a number of certainties could be drawn. It was almost universally accepted that these two essential variants of white-collar crime were not only extremely difficult to detect and investigate but also, more importantly, prosecute. Five years on, little has changed. What has emerged is growing support for reform of an area seen as shackled with fundamental flaws. Whilst most research has tended to focus on one or two distinct issues, the published research does not amount to a coherent overview of the problem. Indeed, of those studies that have emerged they have either tended to be out of date or centre on general criminological aspects of white-collar fraud. Accordingly, little research has been attempted on specifically examining all the problems and the feasibility of all the possible reforms directly applicable to insider dealing and market manipulation. This is the crux of this research.

Given the elusiveness of insider and manipulative activities, any success on the part of those involved in its interception has attracted media attention. Yet the majority of this attention has tended to focus on sensationalising the inadequacies of the very systems used to combat such fraudsters. From this perspective it can be deduced to be a high profile area. However, given the small number of convictions actually achieved growing criticism has arisen (some would argue rightly so) and consequently the present system used in the United Kingdom has been perceived by many as being wholly inadequate. Paradoxically, it is generally acknowledged in the City that these types of fraud take place on a daily basis and some are of the opinion that there is nothing wrong in carrying it out. Those that are caught, they quip, deserve it because they are not careful enough. Others are of the opinion that those caught are sacrificed. So what can be done if such views prevail?

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structural differences that are usually apparent. However, guidance may be inferred given that in many areas the two legal systems have similarities and have in many ways influenced each other.

Chapter six scrutinises and assesses the appropriateness of the role criminal prosecutions play in dealing with these categories of securities law violation. Generally, key issues relating to the prosecution of financial fraudsters will be critically examined to assess their relevance. As a consequence, reformist views of this area will be put forward along with the problems that may be encountered in their implementation. Again, a comparative approach is used throughout this chapter.

Chapter seven critically analyses the issue of extraterritoriality and its impact on fraud investigations. This chapter seeks to highlight the problems and the possible ways in which they may be improved by looking to the United States for answers.

The final chapter outlines what practical solutions to the problems associated with regulatory enforcement can be deduced in light of the issues analysed. Findings are also drawn from earlier chapters.

Section One

The purpose of this thesis is to examine the appropriateness of the procedural and substantive issues that relate to insider dealing and market manipulation. In order to achieve this aim the use of American law and its legal system have been analysed. The reasons for choosing this jurisdiction will become apparent upon the reading of this research. For the sake of clarification the thesis is divided into three broad categories, each of which incorporates a number of chapters. Thus, chapters that fall under section one (chapters one and two) examine the theoretical and philosophical aspects that underpin this work. Section two (chapters three and four) examines the substantive issues relating to these forms of market abuse. Lastly, section three (chapters five, six and seven) examines the theoretical and procedural aspects related to detecting, investigating and prosecuting insider dealing and market manipulation and the problems associated with each facet.

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Chapter One

Setting the Scene: Problems Policing the City

Overview

The purpose of this chapter is to provide a broad basis of understanding apropos to this research. This is attained through examining the three issues that permeate this thesis. Firstly, a historical foundation is provided, briefly examining the factors that have significantly influenced the moulding of the current financial markets of the United Kingdom. Secondly, a general consideration of the meaning of white-collar crime and how the categorisation of insider dealing and market manipulation falls within such a broad definition is given. Finally, the key problems that relate to enforcing regulation against these two activities are identified so that each issue can be developed in subsequent chapters.

1.1. Growth of the City: Influential Factors and its Affect

1.1.1. Modes of Historical Market Regulation

Since the seventeenth century the city of London has always been perceived as one of the world's main financial centres.¹ Originally, this importance was drawn from its versatility as a trading port and its venerable readiness to attract trade from distant shores offering rare yet highly desirable items. Consequently, as its popularity grew, particularly with the development of British maritime power and the program of colonisation, it became more powerful than Amsterdam, one of the first true financial markets. With power came influence and through the combination of: embracing the doctrine of *laissez-faire* ideals,² high productivity yields and parochial practices by market professionals. Dramatic influential changes established the parameters by which these markets developed, a fact that greatly influenced both Governmental and Sovereign hold over City practices. The City became little more than an exclusive club, a state of affairs some still argue is true today.³ Yet, even during these times such financial markets were often affected by fraudulent activity that permeated many so-called legitimate securities transactions.⁴ Consequently, during the reign of *Edward VI* a number of laws were enacted to combat the growing tide of fraudulent activity and so the actions of 'forestalling',⁵ 'engrossing'⁶ and 'regrating'⁷ were

¹ Ingham, G.(1984), *Capitalism Divided? The City and Industry in British Social Development*, London: Macmillan, at 40.

² Ingham, G. (1984), *op. cit.*, at 130 *et seq.*.

³ Entry into the City was through either family ties or knowing of someone in the City. Once in position continued membership heavily relied on the principle of honour towards fellow members, with the adoption of trust or the 'my word is my bond' approach.

⁴ For a detailed historical perspective on these practices *see post*, chapters three and four. However, *see generally* Morgan, E.V. and Thomas, W.A. (1962), *The Stock Exchange - Its History and Functions*, London: Elak Books.

⁵ 'Forestalling' was thus defined:

'That whatsoever person or persons... shall buy or cause to be bought, any merchandise, victual, or any other thing whatsoever, coming by land or by water toward any market or fair, to be sold in the same... or make any bargain, contract, or promise, for the having or buying of the same, or any part thereof, so coming as is aforesaid, before the said

criminalized.⁸ Moreover, there are also many examples of attempts being made to regulate other malpractices viewed as equivalents to fraud during the seventeenth to nineteenth centuries.⁹ To some the extent of regulation imposed on stock-jobbers and brokers in the City during this time can be seen as being stricter than under the regime currently used in this country. Thus, under the *Statute of 1696* stock-jobbers had to obtain a licence, swear an oath to deal '*without fraud and collusion*', adhere to '*good practices*' and record transactions. They were also required to post bonds of approximately £500 that could be forfeited for '*misconduct*'. Draconian penalties were also provided, including a fine up to £500, disqualification and public censure.¹⁰ However, given the number and extent to which the City enacted such laws it rarely

merchandise, victuals, or other things, shall be in the market, ... ready to be sold; or shall be in the market, letter, message, or otherwise, to any person or persons, for the enhancing of the price, or dearer selling of any thing or things above-mentioned, or else dissuade, move, or stir, any person or persons coming to the market... to abstain or forbear to bring, or convey to the market ... to abstain or forbear to bring, or convey any of the things above rehearsed, to any market ... shall be deemed ... for a forestaller.'

; (1552) 5 and 6 Edw. VI c. 14.

6 'Engrossing' was defined as:

'That whatsoever person or persons ... shall engross or get into his or their hands, by buying, contracting, or promise taking, other than by demise, grant, or lease of land or title, any corn growing in the fields, or any other corn or grain, butter, cheese, fish of other dead victuals whatsoever, within the realm of England, to the intent to sell the same again, shall be accepted, reputed, and taken an unlawful engrosser.'

; *op. cit.*

7 'Regrating' was defined as:

'That whatsoever person or persons ... shall by any means regrate, obtain, or get into his or their hands or possession, in a fair or market, any corn, or other commodities, that shall be brought to any fair or market within this realm ... to be brought to any fair or market within this realm ... to be sold, and do sell the same again in any fair or market holden or kept in the same place, or in any other fair or market within four miles thereof, shall be ... taken as a regrater.'

; *supra*, note 5.

8 Illingworth, *Forestalling*, (1800), at 67 and Turner (ed.), *Russell on Crime*, (1964), at Chapter one hundred.

9 Morgan, E.V. and Thomas, W.A. (1962), *supra*, note 4, at chapter one.

10 Rider, B.A.K., Abrams, C. and Ferran, E. (1992), *Guide to the Financial Services Act*, Bicester: CCH, at chapter one; Rider, B.A.K. and Ashe, T.M. (1993), *Insider Crime - The New Law*, London: Jordans, at 2 *et seq.*; and Kirk, D.N. and Woodcock, A.J.J. (1996), *Serious Fraud: Investigation and Trial*, London: Butterworths, at chapter one.

intervened in such matters due to the exclusivity bestowed upon it by fellow members.¹¹ So defensive was the City about regulation that it vigorously resisted any attempts made by the courts and Parliament to intervene.¹² Of those eventually penalised the majority were perceived as piece-meal offerings. The real crooks were never caught!¹³ Interestingly, this is in stark contrast to other societies who vehemently adhered to regulatory principles. In ancient China and Egypt, for instance, both societies set about imposing regulation of their commodity markets to prevent abuses such as cornering and misrepresentation from becoming firmly established. With regards to the latter jurisdiction, rules were created which related to stabilising the commodity markets by outlawing persons from rural areas purchasing more than a shih of rice in Peking,¹⁴ and even strikes by ferrymen were published as interfering with the proper functions of the markets.¹⁵

¹¹ Members of the market world who were believed to have carried out dubious transactions were simply ostracised from City life; Sugarman, D. and Rubin, G.R. (eds.) (1984), *Law, Economy and Society, 1750 – 1914: Essays in the History of English Law*, Abingdon: Professional Books Limited, at 195 *et seq.*

¹² Robb, G. (1992), *White-Collar Crime in Modern England, Financial Fraud and Business Morality: 1846-1929*, Cambridge: Cambridge University Press, at 85 *et seq.*

¹³ See, for example, *The Times*, 3rd May 1858.

¹⁴ Boulais, J. (1924), *Manuel du code chinois* (Varieties sinologiques series number 55), at 754.

¹⁵ See the memorial of the Governor-General of Kiangsu, concerning Hou-Ming-Chang, who was duly decapitated for '*restraining trade*'; Hsing-an hui-lan, Shanghai, at 6.10/20b-21a.

1.1.2. *New Technology, New Investments, New Problems*

Today's financial markets are not too different from those markets of old in this respect, as fraud has always accompanied market growth and development. Yet, where these two markets differ is in the way technological development has played an important role in running today's financial markets.¹⁶ The increased use of information technology has made paperless transactions a reality. Computerisation and fibre optic telecommunication can provide global market changes, and abuses, on a rapid scale.¹⁷ Hence, market transactions have become global and subsequently:

"... allow[ed] investors in London to trade as easily on those financial markets in New York as they can on their own markets..."¹⁸

Although securities trading is now globally based, the City has continued to thrive. This is partly due to its expansion into foreign currency¹⁹ and equities,²⁰ junk

¹⁶ For an insight into the evidential problems associated with 'paperless' transactions; *post*, chapters five and six. Also, see Salako, S. (1992), 'Transition to a 'Paperless' System Using EDI Techniques: the Evidential Minefield', International Yearbook of Law Computers and Technology, Vol. 6, at 59 *et seq.*

¹⁷ Atkinson, D. (1997), 'Call for Special Courts to Deal with Cyberspace Crime', *The Guardian*, 19/6/97; Nuttall, A. (1997) 'Internet Investors Urged to Beware of Fraudsters', *The Times*, 22/8/97 and Securities and Investment Board Press Release on Bogus Web Sites, PN/SIB/33/97, 21/8/97.

¹⁸ Soloman, D. (1991), 'The Impact of Technology on the Trading of Securities: The Emerging Global Market and the Implications for Regulation', John Marshall Law Journal, Vol. 24, at 299 and McRae, H. and Cairncross, F. (1991), *Capital City: London as a Financial Centre*, London: Methuen, at chapter one.

¹⁹ For a discussion of the impact Eurodollar markets have had on the United Kingdom see Harvey, D. (1989), *The Condition of Postmodernity*, Oxford: Basil Blackwell; at 123 *et seq.* In addition see Regulation D and Q of the United States Federal Reserve regarding requirements taken by United States banks on deposit making in Europe and the ceiling rate on interest payable on time deposits respectively.

²⁰ "... The total cash value of all transactions in foreign equities reported to the Exchange by its member firms [in 1996] exceeded £1,000 billion for the first time – an 850 per cent increase over the last 10 years..."

; *Minutes of Evidence: Treasury Committee on the Stock Exchange*, 12/2/97, at 2.

bonds²¹ and derivative markets.²² Although derivative trading is not a new phenomenon²³ the impact this form of trading has made on the City in the last two decades is formidable, as the City's overall annual turnover is now considerably higher than many other developed markets. However, it is the United States and especially American banks, which can be seen to trade more extensively than any other country or organisation. Yet, as more emphasis is placed on these markets, with their ability to generate vast capital sums, the problem of how to best regulate them has become more apparent.²⁴ This has been magnified in recent years by the high profile financial investigations brought into focus by Barings Bank²⁵ and the Sumitomo Corporation.²⁶ Fears associated with the abuse of derivatives centres around the notion that because of the types of:

“... modern financial markets, the types of risks involved and the speed of change of exposure as well as the variety of the arbitrage opportunities available.”

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- 21 See generally ‘Insider Trading in Junk Bonds’, (1990) Harvard Law Review, at 1720 and ‘Who Dares Wins Wall Street’, *The Independent*, 16/4/95.
 - 22 See generally Thomson, R. (1998), *Apocalypse Roulette: The Lethal World of Derivatives*, London: Macmillan, for an account of the many problems and scandals associated with derivative markets.
 - 23 Swan, N. (ed.) (1993), *The Development of the Law of Financial Services*, London: Cavendish Publishing, at chapters one-three.
 - 24 Walker, B. (1996), ‘Financial Derivatives - Global Regulatory Developments’, *Journal of Business Law*, at 66; *S.I.B. Guidance Release, Advice Under Section 206 of the Financial Services Act 1986-Equity-related Derivatives: Use of Inside Information*, December 1996 and Peston, R. and Wighton, P. (1995), ‘DTI Scans Swiss Bank Derivatives Dealings’, *The Financial Times*, 20/1/95.
 - 25 See generally Board of Banking Supervision, *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings*, Bank of England, 18/7/95.
 - 26 Gooding, E and Denton, J. (1996), ‘Sumitomo Copper Market Loss May Double to \$4bn’, *The Financial Times*, 22-23/6/96; ‘The Same Old Story of Many Warnings Ignored’, *The Independent*, 18/6/96 and Dawkins, F., Nakamoto, J. and Gooding, E. (1996), ‘Rogue Deals Cost Sumitomo \$1.8bn’, *The Financial Times*, 14/6/96.

Regulation of these markets has therefore proven to be less than effective. As a result a number of reports have been analysed to consider how to best regulate these markets whilst at the same time not stifling natural growth through over-regulation.²⁷

One of the great attractions of derivative trading is that by their very nature they are malleable financial products, able to be adapted to fit a number of different circumstances at different times. Yet some are extremely complex arrangements created on assumptions related to probability, volatility and future costs. In their most basic form derivatives can be divided into three categories:²⁸

- (i) futures²⁹ - which are promises to purchase or sell a particular commodity or security at a set price on a set date (often in a set place) in the current future;
- (ii) options³⁰ - which can be divided into two categories: ‘*put*’ options, which are financial instruments granting the party paying the deposit the right, and its counterparty the obligation to receive, or deliver the underlying instrument to the counterparty at a given price on a given date, and ‘*call*’ options, which give the party paying the deposit the right to receive and its counterparty the obligation to deliver the instrument concerned; and
- (iii) swaps³¹ - often refers to an exchange of cash flows that are calculated from a rate in a currency, or currencies, or two interest rates - often fixed and floating. Normally the net difference is the only sum payable.

²⁷ Walker, B. (1996), *supra*, note 24, at 90 *et seq.* and Rider, B.A.K. (1985), ‘*Protecting the Prudent Investor*’, *Company Lawyer*, Vol. 6, No. 2, at 54.

²⁸ *Global Derivatives Study Group, Derivatives: Practice and Principles, Group of 30 [the G. 30 Global Derivatives Group]*, July 1993, at 33 *et seq.*

²⁹ See generally Fitzgerald, E. (1983), *Financial Futures*, London: IFR Publishing Ltd.

³⁰ *G. 30 Global Derivatives Group* (1993), *supra*, note 28, at 33.

³¹ *G. 30 Global Derivatives Group* (1993), *supra*, note 28, at 31.

Financial markets have become of increasing importance in the part they play in providing financial and economic benefits to the societies that rely on them.³² Yet, with the internationalisation of financial transactions it can be observed that a sacrifice has been made, for these very markets have become the victims of their own success. The technology that has assisted them has facilitated international market frauds of such magnitude that the enforcement laws and bodies used against these practices have seemed powerless to stop them.³³ Consequently, the majority of securities frauds that are unearthed today not only seem larger but more complex than those previously encountered.³⁴ Paperless transactions are purposely created and spun through a myriad of jurisdictions, especially where banking secrecy laws operate,³⁵ and nominee accounts³⁶ in an effort to lose investigators.³⁷

32 “... At the heart of any successful free enterprise economy there must be efficient capital and financial markets.... if the Stock Exchange had been left as it was, it is clear that it would not have been able to resist substantial erosion of its business from better capitalised U.S. and Japanese financial houses. (Therefore)... the Government has a clear responsibility to provide an adequate regulatory framework that will maintain the stability and integrity of the system without a degree of over-regulation that would drive business to centres with more liberal regimes...”

; Mr Nigel Lawson, *Financial Services Act 1986, Introduction and General Note*, at 11. Also see *House of Commons Trade and Industry Committee Third Report on Company Investigations*, (1990), at v.

33 Shapiro, S.P. (1990), ‘*Collaring the Crime, not the Criminal*’, *American Sociological Review*, Vol.55, at 353 and Reichman, N. (1993), *Insider Trading*, in Toney, M. and Reiss, A.J. Jr (eds.), *Beyond the Law, Crime in Complex Organisations*, University of Chicago Press: Chicago, at 70 *et seq.*

34 Reichman, N. (1993), *op .cit.*, at 56 and Markham, K. (1989) ‘*Front-Running – Insider Trading under the Commodity Exchange Act*’, *Catholic University Law Review*, Vol. 38, at 69 *et seq.* The concept of fraudulent trading is not a new notion. Geis, G. and Edelhertz, H. have suggested that the biblical reference of Christ driving out the money-lenders from the temple represents an early “response of moral outrage against business cheating and indecency”; ‘*Criminal Law and Consumer Fraud: A Socio-Legal View*’, (1973) *American Criminal Law Review*, at 990. Even in the times of Homer fraud that led to abuse of commercial market integrity, was particularly prominent; with such fraudsters referred to as “*tricksters dealing in countless and worthless trinkets to the scandal of the market*”, Anderson, B.L. and Latham, A.J.H. (eds.) (1986), *The Market in History*, Croom Helm: London. Indeed, insider dealing has been prevalent since the seventeenth century; Naylor, J.M. (1990(a)), ‘*The Use of Criminal Sanctions by United Kingdom and United States Authorities for Insider Trading: How Can the Two Systems Learn from Each Other? Part I*’, *Company Lawyer*, Vol. 11, No. 3, at 54.

35 Collins, T. (1986), ‘*Banking Secrecy and the Enforcement of Securities Legislation*’, in Goode, R.M. (ed.), *Conflicts of Interest in the Changing Financial World*, Institute of Bankers: London, at 84 *et seq.*; Hurd, D. (1986), ‘*Insider Trading and Foreign Bank Secrecy*’ *American Business Law Journal*, Vol. 24, at 26 *et seq.*; Suter, J. (1989), *The Regulation of Insider Dealing in Britain*, London: Butterworths, at 356 *et seq.*; Lucas, L. (1992), ‘*Protection from International Fraud – Legal and Enforcement Developments: Part I*’, *Company Lawyer*, Vol. 13, at 206 *et*

1.2. Insider Dealing and Market Manipulation - Its Relationship with White-Collar Crime

1.2.1. Sutherland's Definition of White-Collar Crime

Insider dealing and market manipulation is often referred to as falling within the category of 'white-collar crime'.³⁸ Yet, little is understood about this concept and how it relates to the aforementioned securities practices and so, consequently, little research has been attempted in this area.³⁹ The purpose of this section is to clarify how and why insider dealing and market manipulation fall under this heading and examines the controversy that surrounds this term and its inclusion in criminal studies.

The meaning of white-collar crime has always been synonymous with the definition given by *Sutherland*, who defined it as:

seq.; Fedders, J.M. (1985), 'Policing Trans-Border Fraud in the United States Securities Markets: The Waiver by Conduct Concept – A Possible Alternative or Starting Point for Discussion', *Brooklyn Journal of International Law*, Vol. 11, at 487 *et seq.*; Pitt, H. (1978), 'Problems of Enforcement in the Multinational Securities Market', *University of Pennsylvania Journal of International Business Law*, Vol. 9, at 405 *et seq.*; Charter, K. and Beck, I. (1978), 'Problems of Enforcement in the Multinational Securities Market', *University of Pennsylvania Journal of International Business Law*, Vol. 9, at 469 *et seq.*; Meyer, L. (1978), 'Swiss Banking Secrecy and its Legal Implications in the United States', *New England Law Review*, Vol. 14, at 20 *et seq.*

36 Rider, B.A.K. and Ffrench, H.L. (1979), *The Regulation of Insider Dealing*, London: Macmillan, at 419.

37 See generally Robinson, J. (1994), *The Laundrymen*, New York: Simon and Schuster and Stewart, J. (1991), *Den of Thieves*, New York: Simon and Schuster.

38 Stanley, C. (1992), 'Serious Money: Legimation of Deviancy in the Financial Markets', *International Journal of the Sociology of Law*, Vol. 20, at 44 *et seq.*; Clarke, M. (1990), *Business Crime: Its Nature and Control*, Cambridge, Polity Press, at 162 *et seq.* and Snider, L. (1991), 'The Regulatory Dance: Understanding Reform Processes in Corporate Crime', *International Journal of the Sociology of Law*, Vol. 19, at 209 *et seq.*

39 Levi, M. (1987), *Regulating Fraud: White Collar Crime and the Crime Process*, London: Tavistock, at xx-xxi.

“... a crime committed by a person of respectability and high social status in the course of his occupation.”⁴⁰

Sutherland's approach sought to justify this assertion by focusing on class status, occupation, social organisation and differential association.⁴¹ This latter issue has been explained through behavioural tendencies, whether they are criminal or otherwise, being learned from social and environmental influences.⁴² He argued that ordinary criminal behaviour did not satisfy these criteria and therefore was equated to personal and social pathologies. White-collar crime, he believed, was restricted to crime committed in the course of legitimate occupation. *Sutherland* described and analysed many forms of white-collar crime following this definition, including activities which were not, at the time, sanctioned by the criminal law, but which, being violations of civil or administrative law, were likely to lead to legal responses. However, this in conjunction with his stress on the social status of the offenders attracted considerable criticism⁴³ leading to the assertion that his theory could be likened to ‘*futile terminological disputes*’⁴⁴ or a ‘*nebulous definition*.’⁴⁵ Nevertheless, *Sutherland's* theory is still universally recognised as providing the fundamental basis for what amounts to white-collar crimes and cannot, therefore, be easily discounted.⁴⁶

40 Sutherland, E. (1940), ‘*White Collar Criminality*’, *American Sociological Review*, Vol. 5, at 1 *et seq.*

41 Durkheim, E. (1960), ‘*The Dualism of Human Nature*’ in Wolff, E. (ed.), *Emile Durkheim et al: Writings on Sociology and Philosophy*, London: Routledge.

42 Coleman, J.W. (1992), ‘*The Theory of White Collar Crime, from Sutherland to the 1990's*’ in Schlegel, K. and Weisburd, D. (eds.), *White Collar Crime Reconsidered*, Boston: Northeastern University Press, at 54.

43 Coleman, J.W. (1992), *op. cit.*, at 53 *et seq.*

44 Aubert, V. (1977), ‘*White Collar Crime and Social Structure*’ in Geis, G. and Meier, R.F. (eds.), *White Collar Crime: Offences in Business, Politics and the Professions-Classic and Contemporary Views*, New York: The Free Press, at 88 and Tappen, P.W. (1947), ‘*Who is the Criminal?*’, *American Sociological Review*, Vol. 12, at 99 *et seq.*

45 Geis, G., ‘*White Collar Crime. What is it?*’, in Schlegel, K. and Weisburd, D (1992), *op. cit.*, at 253 *et seq.*

46 Shapiro, S.P. (1989), ‘*Collaring the Crime, Not the Criminal: Reconsidering the Concept of White-Collar Crime*’, *American Sociological Review*, Vol. 55, No. 3, at 357.

1.2.2. *Subtle Differences and White-Collar Crime Today*

Despite the fact that *Sutherland's* definition also included reference to examples of practices that involved liability other than criminal law, many criminologists have debated what specific elements are needed to constitute white-collar crime.

Consequently, many have offered opposing hypothesis. *Quinney*,⁴⁷ for instance, has concentrated on defining white-collar crime through notions of occupational crime, whilst *Edelhartz*⁴⁸ has sought to do the opposite, by removing the notion that white-collar crime can be committed in the workplace. *Clinard and Yeager*⁴⁹ offer yet another perspective, arguing that white-collar crime can be committed both in occupational and corporate roles.⁵⁰ However, it is *Braithwaite* who identified the position best. He suggested that defining crimes by the characteristics of the perpetrators results in:

“... an unfortunate mixing of definition and explanation.”⁵¹

However, more recently, modern criminologists such as *Shiparo* and *Croall*⁵² have tended to reformulate a more fluid definition of what white-collar crime amounts to. While *Shiparo* has tended to concentrate on defining white-collar crime through

⁴⁷ Quinney, R. (1964), ‘*The Study of White Collar Crime: Toward a Reorientation in Theory and Research*’, 55(2) *Journal of Criminal Law, Criminology and Police Science*, Vol. 55, No. 2, at 63..

⁴⁸ Edelhertz, H. (1970), *The Nature, Impact and Prosecution of White Collar Crime*, U.S. Government Printing Office: Washington, at 78.

⁴⁹ Clinard, M.B. and Yeager, P.C. (1980), *Corporate Crime*, New York: The Free Press, at 18 *et seq.*

⁵⁰ Clinard, M.B. (1983) in a later study, clarified corporate crime as:

“... illegal corporate behaviour which is a form of collective rule breaking in order to achieve the organisational goals...”

; *Corporate Ethics and Crime*, New York: The New Press, at 17.

⁵¹ Braithwaite, J. (1985), ‘*White Collar Crime*’, *Annual Review of Sociology*, Vol. 11, at 22.

⁵² Croall, H. (1992), *White Collar Crime*, Milton Keynes: Open University Press, at 12 *et seq.* and Croall, H. (1989), ‘*Who is the White Collar Criminal?*’, *British Journal of Criminology*, Vol. 29, No. 2, at 157 *et seq.*

correlating general individual characteristics with how these relate to the betrayal of trust, *Croall* hypothesises that a number of factors are needed. These factors include:

- **Low Visibility**

An essential feature of white-collar crime is that it usually takes place under the cover of normal occupational routines, and involves the exploitation of occupational expertise or organisational systems. They can therefore be readily disguised as:

“... *business offenders are legitimately present at the scene*”.⁵³

All of this means that victims are often unaware that any offence has been committed at all. In addition, offences are generally ‘*private*’ rather than public, leaving little discernible evidence of their commission. This relative invisibility means that offences are particularly resistant to detection, and, even when detected, are often not reported to public authorities.

- **Complexity**

While many white-collar crimes can essentially be reduced to lying, cheating and stealing, many are extremely complex. The expertise that is being abused, which forms the basis of the offender’s occupational position, may be scientific, technological, financial or legal. Many are also highly organised,⁵⁴ involve many employees, and may have been going on for a considerable period. Organisational offences may involve a complex web of falsifications, cover ups, action and inaction. Many of the regulations and laws which are flouted are themselves exceedingly

⁵³ Clarke, M. (1990) *Business Crime: Its Nature and Control*, Cambridge: Polity, at 21 *et seq.*

⁵⁴ Murphy, P. (1997), ‘*Investigators Play Numbers Game*’, *The Guardian*, 25/8/97 where it was reported that the Stock Exchange surveillance department was monitoring the ‘*Monaco Mob*’.

complex, making it difficult to determine exactly what offences have been committed and who is responsible for them.⁵⁵

- **Diffusion of Responsibility**

The division of labour within occupations and organisations, in which functions are separated and responsibilities delegated further compounds this complexity. Consequently, it is often difficult to determine who is immediately responsible for any offence. This is particularly the case with organisational offences that may involve neglect or deliberate flouting of the many regulations. Finding out whose actions have directly caused specific problems may be difficult enough, let alone determining who is morally or legally responsible. Individual employees may ignore regulations but their supervisors may be blamed for inadequately monitoring their performance. In turn, several levels of management may be blamed for employers responsible for instituting systems to ensure adequate compliance. At all levels of the chain of responsibility therefore individual employees can deny responsibility by claiming that they were only '*following orders*' or that their orders were ignored.

This means that in practice it is often difficult to assign blame or to find the '*guilty party*'. In addition, many organisational offences do not result from any criminal intent. Neither the employees whose inattention to safety may directly cause an accident, nor the supervisors and company directors who have neglected their responsibilities, can normally be accused of intending to kill, injure or defraud employees or consumers. This means that many organisational offences are less likely to be defined as '*criminal*', a definition that normally involves notions of individual blame and intent.

⁵⁵ Passas, N. and Nelken, D. (1993), '*The Thin Line Between Legitimate and Criminal Enterprise: Subsidy Frauds in the European Community*', Crime, Law and Social Change, Vol. 19, at 223 *et seq.*

- **Diffusion of Victimisation⁵⁶**

Whereas in many conventional offences individual identifiable offenders harm individual identifiable victims, in many white-collar offences there is no single identifiable victim.⁵⁷ The victim may be an abstract entity such as the government or the company, or there may be victims who suffer only a minimum loss. *Sutherland* pointed out the ‘*rippling effect*’ of white-collar crimes, many of which involve only a small loss to individual victims but enormous gains to the perpetrators. This makes many white-collar offences less readily definable as crime. This is aptly illustrated by *Box*’s analogy that:

‘... the public understands more easily what it means for an old lady to have five pounds snatched from her purse than to grasp the financial significance of 25 million customers paying one penny more for orange juice diluted beyond the level permitted by law. The public tends to focus more on one penny than the quarter of a million pounds illegal profit and conclude that the incident is insignificant. But it is not...’⁵⁸

- **Difficulty in Detection and Prosecution⁵⁹**

A major consequence of all these factors is that white-collar crime is particularly difficult to detect by victims, compliance officers or law enforcers. Therefore, enforcers must possess the same scientific and technical expertise as perpetrators and it may take weeks, months or even years of careful investigation to unravel the more complex offences. Examination of company records, bank accounts is both time-

⁵⁶ Most securities violations are committed through faceless transactions therefore determining who is the victim in such cases causes problems; *see post*, chapter two.

⁵⁷ Levi, M. and Pithouse, A. (1992), ‘*The Victims of Fraud*’, in Downes, D. (ed.), *Unravelling Criminal Justice – Eleven British Studies*, London: Macmillan, at 229 *et seq.*

⁵⁸ Box, S. (1983), *Power, Crime and Mystification*, London: Tavistock, at 31 *et seq.*

⁵⁹ *See generally* Levi, M. (1993), *The Investigation, Prosecution, and Trial of Serious Fraud*, The Royal Commission on Criminal Justice, Research Study No. 14, London: HMSO.

consuming and costly. Effective enforcement often has to be proactive and preventative, rather than reactive, responding to the minority of offences that are discovered. However this is also costly, either for individual businesses or public agencies, and as will be seen, the high costs of detection leave many offences undiscovered.

Even when offences are detected, it may be difficult to prove that an offence has been committed and to establish who is responsible for it.⁶⁰ The complexity of many offences creates difficulties for establishing legal proof, and key witnesses may be reluctant to divulge information to investigator particularly where it may incriminate them as well.⁶¹

- **Lenient Sanctions**

Even when prosecuted, it is often argued that white-collar offenders are not dealt with severely.⁶² Few are sent to prison and the vast majority are fined amounts that are reasonably described as derisory.⁶³ While this needs to be put in the context of the high status of offenders, it is also related to the offences themselves. Offenders who can credibly claim that they didn't intend to cause any harm and in any case are not directly responsible may well be seen as not really criminal. The absence of violence and the diffusion of victimisation also means that offenders are not likely to be seen as '*dangerous*'. They are often first time offenders because this is the first time they have been caught and they can also claim that they have already been punished by losing their reputation or livelihood.

⁶⁰ Braithwaite, J. and Geis, G. (1982), '*On Theory and Action for Corporate Crime Control*', *Crime and Delinquency*, April, at 292 *et seq.*

⁶¹ See generally Mann, K. (1985), *Defending White Collar Crime*, New Haven: Yale University Press.

⁶² The general trend is that the majority of securities law violators tend to either receive little or no punishment for their acts; Hagan, J. and Parker, P. (1985), '*White-Collar Crime and Punishment: The Differential Sentencing of White Collar Offenders in Ten Federal Courts*', *American Sociological Review*, at 312 *et seq.*

⁶³ Levi, M. (1989), '*Suite Justice: Sentencing for Fraud*', *Criminal Law Review*, at 420 *et seq.*

- **Ambiguous Laws⁶⁴**

The nature of offences also creates many legal problems. Their complexity means that it is often difficult to capture the essence of offences in legislation and to specify precisely the situations in which an offence has been committed, leaving many loopholes to be exploited. For some offences, as soon as one illegal practice is prohibited another practice is developed which evades the provisions of any particular statute. The law therefore has to keep pace with offenders whose very success depends on their ability to stay one step ahead of the law. For example, laws controlling tax evasion have to keep up with increasingly complex avoidance schemes, and laws attempting to regulate City fraud must take account of new technical and financial innovations. Moreover, the fine dividing line between legal and criminal, acceptable and unacceptable behaviour means that law must keep up with changing standards of public tolerance. The diffusion of responsibility in organisations also means that it is difficult to determine who is legally and criminally responsible, leading to problems in deciding who should be prosecuted, and whether a company can be legally ‘guilty’ of an offence.

- **Ambiguous Criminal Status.⁶⁵**

The narrow borderline between legality, illegality and criminality makes the criminal status of many offences ambiguous. For many, organisational offences the underlying rationale for the use of the criminal law, is not that the activities in question are morally wrong but that they must be regulated in order to protect the public.

64 There is often a fine dividing line between city practices between what is regarded as standard practice and something which borders on attracting civil or criminal liability; Nelken, D. (1994), ‘White Collar Crime’ in Maguire, M., Morgan, R., and Reiner, R. (eds.), *The Oxford Handbook of Criminology*, Oxford: Clarendon Press, at 375. Therefore, laws regulating against city fraud must keep track of newly evolving fraudulent techniques; Clarke, M. (1986), *Regulating the City: Competition, Scandal and Reform*, Milton Keynes: Open University Press, at chapter six and Hadden, T. (1983), ‘Fraud in the City: The Role of the Criminal Law’, *Criminal Law Review*, at 501.

65 With regard to arguments relating to how insider dealing and manipulative practices may be perceived as normal market practice, *see post*, chapters three and four.

Taking all these characteristics into account, it can be perceived that relatively few white-collar offences are detected, prosecuted and publicly punished. Clearly, some of these characteristics are more typical of some forms of white-collar crime than others. However, for many occupational offences, the borderline between what are acceptable '*perks*' and outright fraudulent behaviour is difficult to determine. Similarly while the diffusion of responsibility and victimisation is taken to be a central feature of organisational crime, many occupational crimes involve many participants, some of whom may be less directly implicated than others, and they can also involve diffuse and impersonal victims.

These characteristics also broadly distinguish white-collar crime from others, although this distinction can be overdrawn. The determination of some conventional offences also involves drawing a fine line between the legitimate and the criminal, and there are other offences whose criminal status is problematic.

From the above critique therefore it seems that no one satisfactory definition of white-collar crime exists. However, from the recent research carried out by *Croall*⁶⁶ it seems that both insider dealing and market manipulation fall into what can be classed as white-collar crime. Therefore, the writer has adopted this approach in this thesis and accordingly will examine all of the above fractural elements derived from the above definition.

66 *Post.*

1.3. Regulatory Enforcement - Uncovering the Problems

1.3.1. Market Productivity and Investor Confidence

It has become apparent over the last decade that investment institutions in the United Kingdom have placed increased emphasis on the benefits that can be gained through private or institutional investment.⁶⁷ Yet, with the advent of wider share ownership and the proliferation of organisations providing financial services,⁶⁸ financial markets have created new opportunities for fraud through the exploitation of the weaknesses of existing regulatory structures;⁶⁹ a notion aptly summarised by *Lord Roskill* who noted that the Government of that era:

“... [had] encouraged and continues to encourage ordinary families to invest their savings in the equity markets, particularly in the equities of former state-owned enterprises. If the Government cherishes the vision of an ‘equity-owning democracy’, then it also faces an inescapable duty to ensure that financial markets are honestly managed, and that

⁶⁷ Page, A.C. and Ferguson, R.B. (1992), *Investor Protection*, London: Weidenfeld and Nicolson, at 9:

“... Modern surveys of shareholdings in companies listed on the Stock Exchange indicate the growth in importance of institutional investors (and hence of indirect investment). Between 1963 and 1990 the proportion of shares held by unit trusts grew from 1.3 per cent to 6.1 per cent; by insurance companies from 10 per cent to 20.4 per cent; and by pension funds from 6.4 per cent to 31.4 per cent. In addition, institutional investors account for more than 40 per cent of market holdings of national debt and are the largest investors in commercial property...”

Also see Ashe, T.M. and Counsell, L. (1993), Insider Trading, London: Fourmat Publishing, at 6. The same trend is also mirrored in the United States; Loss, L. (1995), Fundamentals of Securities Regulation, Boston: Little, Brown and Co, at 4 et seq..

⁶⁸ Chandler, J. (1987), ‘Protecting Investors’ Interest Comes First’, *Accountancy Age* 12/3/87, at 19 et seq..

⁶⁹ Clarke, M. (1990), *Business Crime: Its Nature and Control*, Cambridge: Polity Press, at 183.

*transgressors in these markets are swiftly and effectively discovered, convicted and punished...”*⁷⁰

Thus, the notion that such financial markets are ‘level’ and fair⁷¹ has become an extremely important issue. Investors must have a belief in a system that operates a suitable degree of regulation that is adequately enforced⁷² in order to protect them from fraudulent and manipulative practices.⁷³ Can this be achieved?

At the time of writing it has been argued that the United Kingdom’s methods of enforcement against violators of securities law and regulations are weaker than in many other jurisdictions.⁷⁴ While all but the most naive investor must realise that securities transactions attract risk in that values rise or fall, there are other factors that are not regarded as acceptable.⁷⁵ Hence, one of the main purposes of the present

⁷⁰ *Report of The Fraud Trial Committee*, (1986), at paragraph 1. See also Staple, G. (1998), ‘Time to Take Fraud Seriously’, *The Independent*, 23/2/98 where it has been suggested that some of Roskill’s recommendations are to be implemented.

⁷¹ “... Yet law is basically about fairness; and law is also about the protection of persons from morally reprehensible activity, such as fraud...”

; Breslin, J. (1995), ‘Levels of Playing Field’, *Journal of Financial Crime*, Vol.3, No. 1, at 92.

⁷² Although it has been suggested that excessive regulation would be counter-productive to investors and the market alike; *White Paper on Financial Services in the United Kingdom*, (1985), Cmnd. 9432, at paragraph 1.5.

⁷³ Clark, H. (1997), ‘JP Morgan Fined Over Price Rigging’, *The Times*, 19/12/97.

⁷⁴ “... The United Kingdom’s Regulatory structure is only ten years old, relatively young by the standards of some other countries. It is beginning to show its age, but it works and still has some life in it. But I sense it is beginning to run up against more serious legal obstacles...”

; Richard Farrant, chief executive of the Securities and Futures Authority quoted in ‘Regulation Under Threat Warns SFA Chief Executive’, (1997) *Company Lawyer*, Vol. 18, No. 1, at 19. Additionally, see Fishman, J.L. (1993), ‘A Comparison of Enforcement of Securities Law Violations in the United Kingdom and United States’, *Company Lawyer*, Vol. 14, No. 9, at 170 cf. Rider, B.A.K. (1991), ‘Policing Insider Dealing in Britain’ in Hopt, K.J. and Wymeersch, E.(eds.), *European Insider Dealing*, London: Butterworths, at 324.

⁷⁵ For instance, insider dealing is seen to interfere with the free distribution of market information; *Company Law Reform*, (1973), Cmnd. 5391, at paragraph 15:

“... The efficient operation of the market...(requires) that relevant information (to) be ‘fairly’ available...”

régime of securities regulation in the United Kingdom is to prevent those engaged in fraudulent activities⁷⁶ functioning in the market place. This should facilitate both investor confidence⁷⁷ and market liquidity.⁷⁸ Yet, regulation is a largely futile

; Lowery, M. (1990), *The International Approach to Insider Trading: The Council of European Convention*, Journal of Business Law; Loss, L. (1970), *The Fiduciary Concept as Applied to Trading by Corporate 'Insiders' in the United States*, Modern Law Review, Vol. 33, at 34; and Brudney, H. (1979), *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, Harvard Law Review, Vol. 93, at 322.

76 Even before the advent of the FSA the adequacy of securities regulation had often been debatable:

"....Regulation of the securities industry on a piecemeal basis was seen by many to be inadequate. This view had largely come about by the changing trends within the securities industry itself. At one time the City could be seen as a 'village' with easily controllable citizens. However, the trend towards internationalisation, new investment products, new types of financial services businesses and changes in the securities industry itself demonstrated the need for a more comprehensive regulation of investment business than had previously been the case..."

; Ashe, T.M. and Counsell, L. (1993), *Insider Trading*, London: Fourmat Publishing, at 51. In addition, see Rider, B.A.K. and French, H.L. (1979), *The Regulation of Insider Dealing*, London: Macmillan, at Chapter 6 and Rider, B.A.K. and Hew, E.J. (1979), *The Role of the City Panel on Take-Overs and Mergers in the Regulation of Insider Dealing*, Malaya Law Review, Vol. 20, at 315.

77 See *'Confidence in the Market'*, (1995) Company Lawyer, Vol. 16, No. 7, at 194:

"...If insiders know that the (U.K.) government is not serious in its proclamations, overseas players may take the rhetoric at face value and stay away. This dilemma has become more acute in countries that seek to widen securities ownership as part of a neo-Durkheimian strategy of legitimating so-called popular capitalism in the United Kingdom, the proportion of the population that owns securities has increased to almost a fifth of the adult population, though most of them own very few shares..."

; Levi, M. (1993), *White-Collar Crime: The British Scene*, at 73, in Geis, G. and Jesilow, P. (ed.) (1993), *The Annals of the American Academy of Political and Social Science*, 525, January, Newbury Park, Ca: Sage. Also see *Parliamentary Debates*, 1979/80, 1 Standing Committee 'A', at column 610:

"...We are trying to clean up and strengthen the markets, to make people who are dealing on the public market have more confidence in that market..."

; Prentice, D. (1975), *Insider Trading*, Current Legal Problems, at 91, argues that investor confidence in the market is a product of complex psychological and economic factors and the fact that insider trading is taking place will only have a tangential, if any, bearing on it. In addition, Ashe, T.M. (1988) believes that far from undermining investor confidence the activities of insiders may in fact sustain confidence in the market. The reasons being that insiders are seen as leading indicators in the market and other market actors follow their lead. Also other market actors are led to respond to insiders investment activity in attempts to emulate the insiders' *'superior performance'*; *Insider Dealing*, (1988) Company Lawyer, Vol. 11, No. 7, at 128.

exercise if it cannot be effectively enforced.⁷⁹ Therefore not only does it have to be effective in bringing to justice those who have committed such acts but also to deter others from carrying them out again in the future.⁸⁰ This can only be achieved if adequate regulatory enforcement is undertaken. According to *Fishman*, and upon which the parameters of this thesis are based, regulatory enforcement can be broken down into the following categories:

- **PREVENTION:** through screening and elimination of fraudsters
- **INFORMATION GATHERING:** through effective monitoring systems
- **DETERRENCE:** through swift prosecution and sanctioning of violators.

Thus, proactive and retroactive devices⁸¹ such as these have to be not only vigorously implemented from the very onset of these types of activities being suspected, but, more importantly, they must be wholly adequate in the function for which they supposed to fulfil. It will be only then that the United Kingdom will

78 *Regulation of the United Kingdom Equity Markets: Report by the Securities and Investment Board*, (1995), at paragraph 3.10 *et seq.* and Alcock, A. (1995), 'Insider Dealing-How Did We Get Here?', *Company Lawyer*, Vol. 15, No. 3, at 67.

79 Gower, L.C.B. (1982), *Review of Investor Protection - A Discussion Document*, at paragraph 3.41.

80 Rider, B.A.K. (1985), *Combating International Commercial Crime*, *Lloyd's Maritime and Commercial Law Quarterly*, Vol. 2, at 217.

81 "... Most frauds are still investigated reactively, after the event, but intelligence sources (and, in the case of securities and revenue investigations, regular control visits) do sometimes throw up proactive enquiries. Such proactive enquiries do allow contemporaneous monitoring of responsibility for events- though if informants are involved, there is always a 'filtering' of information (and risk of disinformation) ... whereas reactive enquiries have to reconstruct events with hindsight..."

, Levi, M. (1993), *supra*, note 59, at 22 *et seq.*

impede unsuitable firms or unsavoury characters from infiltrating the market place and engaging in illegal activities.⁸²

⁸² Tieman, R. (1996), '*Lang Outlines Updated Law to Tackle Cartels*', *The Times*, 28/3/96.

1.3.2. *The Growing Seeds of Evil*

The incentives to commit fraudulent crimes are all too clear, given that they concern the potential to make large profits whilst facing little risk of prosecution and even less of facing a prosecution that succeeds.⁸³ It is therefore understandable that these types of white-collar crime have continued to flourish.⁸⁴ Yet, of all those crimes that possess a fraudulent element, those that involve securities transactions as their medium tend to be the most difficult to investigate and prosecute.⁸⁵ Although an elaborate system for monitoring as well as investigating exists in the United Kingdom⁸⁶ it has been repeatedly suggested that it is fundamentally flawed.⁸⁷ Consequently, the use of the criminal law to enforce and deter these activities has drawn a significant proportion of the criticism relating to regulatory enforcement.⁸⁸ It is clear that the regulatory system has not produced the results that were originally envisaged.⁸⁹

83 'When Will We Ever Learn?', (1996) 17(3) *Company Lawyer*, Vol.17, No. 3, at 66.

84 Atkinson, D. (1995), 'Record DTI Investigations', *The Guardian*, 28/9/95 and 'DTI in Fraud Blitz', *The Independent*, 8/9/95.

85 Rider, B.A.K. (1995), 'Global Trends in Securities Regulation: The Changing Legal Climate', *Dickinson Journal of International Law*, Vol. 13, at 532:

"... (The Criminal law) has not proven to be an efficient device in combating economic crime for a host of technical, practical, procedural, and institutional reasons..."

86 *Post*, chapter five.

87 Cohen, P. (1995), 'SFA Chief Calls for Streamlining', *The Financial Times*, 18/5/95; Hellier, D. (1995), 'Fraud Office to Escape the Axe', *The Independent*, 26/3/95; Marckus, M. (1995), 'Shake-Up at Stock Exchange Under Way', *The Times*, 24/11/95; Miller, R. (1996), 'Exchange Could Lose Watchdog Powers', *The Times*, 14/3/96.

88 Bourne, M. (1987), 'Should Insiders End Up Inside?' *Company Law Digest*, Vol. 5, No. 3, at 67 *et seq.*

89 For an insight into the 'value' of the criminal law in this context (1990) *Quality of Markets Quarterly Review*, at 26; *Commons Parliamentary Debates*, 20/11/78, at column 995; *The Times*, 28/9/78, at 21 and *The Times*, 1/11/78, at 23.

Of all the different types of securities frauds that exist, those offences that have tended to prove the most elusive are insider dealing and manipulation.⁹⁰ This is illustrated by the following diagram displayed overleaf, which relates to the former practice:

⁹⁰ Atkinson, D. (1995), '*Trials Without End*', *The Times*, 25/11/95.

	1990- 91	1991- 92	1992- 93	1993- 94	1994- 95	1995- 96	1996- 97	1997 98
Cases referred by the London Stock Exchange for Consideration	8	11	5	17	13	28	36	32
Cases in hand at the beginning of the year	16	9	4	2	6	5	10	18
Appointment of Inspectors	4	3	1	5	6	13	21	22
Final report Submitted by Inspectors	11	8	3	1	7	7	13	17
Cases in hand at the end of the year	9	4	2	6	5	10	18	23
Convictions†								
Following section 177 enquiry	N/A	3	4*	2	N/A	1	N/A	N/A
Total	N/A	3	5**	2	N/A	1	2	N/A
Acquittals								
Following section 177 enquiry	N/A	2	2	5	N/A	N/A	2	N/A
Total	N/A	5	2	6	N/A	N/A	2	N/A

Fig 1.1.

Source:⁹¹

* Includes 3 convictions acquitted on appeal in 1994/95

** Includes 1 conviction acquitted on appeal in 1993/94

† The *Companies Securities (Insider Dealing) Act 1985* was repealed by part V of the *Criminal Justice Act 1993* which came into force on 1/3/94. Thus far there have been no convictions under the *Criminal Justice Act 1993*.⁹²

⁹¹ DTI Report, *Companies in 1994-95*, at 14; DTI Report, *Companies in 1995-96*, at 13; DTI Report, *Companies in 1996-97*, at 14 and DTI Report, *Companies in 1997-98*, at 14.

Paradoxically, although a wealth of academic material exists on insider dealing⁹³ and manipulative practices⁹⁴ little is understood as to the true nature of both offences.⁹⁵ Indeed, it has been suggested the true number of those involved in relation to insider dealing activities will never be known.⁹⁶ Interestingly, this type of activity has not only enticed primary and secondary insiders⁹⁷ involved in either

92 Although Douglas Swinden was brought to court for allegedly committing insider dealing, the case collapsed and a retrial was abandoned; '*Eastern Insider Trial Collapses*', *The Times*, 4/12/96.

93 *Post*, chapter three.

94 *Post*, chapter four.

95 Although it has been suggested that in relation to insider dealing most of these activities will probably take place in relation to take-over operations and other subsequent acquisitions, when a premium value is placed on information and the potential profits from insider dealing are greatest; Rider, B.A.K. (1983), *Insider Trading*, London: Jordans, at 180 and Gower, L.C.B. (1988), '*Big Bang*' and *City Regulation*', (1988) *Modern Law Review*, Vol. 51, No. 1, at 16-17. In addition, it has also been suggested that there are three main types of insiders - opportunists, professionals and the organised groups; Naylor, J.M. (1990(a)), '*The Use of Criminal Sanctions by United Kingdom and United States Authorities for Insider Trading: How Can the Two Systems Learn from Each Other? Part I*', *Company Lawyer*, Vol. 11, No. 3, at 54 and Fagan, A. (1995), '*Aran Rejects £160 million Bid from Acquisitive Arco*', *The Independent*, 22/8/95.

96 Little seems to have changed in the City during the 1970's, 80's and 90's as can be viewed from the following examples.

"... Ten or twenty years ago, there was a fabulous amount of insider dealing in the City. It was part of the ethos of the Stock Market in those days..."

; statement made by Mr Hopkinson, M and G Fund Management Group, *The Times*, 1/11/78.

In a survey amongst the Chairmen of the top 1,000 companies in the United Kingdom in the Autumn of 1987, 42% thought insider dealing often occurred, 32% thought that it did occasionally and only 13% that it never did; Farmery, E. (1987), '*Towards a Tougher Regime Against Insider Dealing*', (1987) *Business Law Review*, at 283. In 1990 the Insider Dealing Group believed that several insider dealing rings were at work dealing through offshore nominees and frequently brought securities months in advance before a deal was announced so as to cover their tracks; *The Independent*, 24/1/90. Indeed, although frequent reference is made, by the media, regarding the existence of insider rings such articles are usually negative in context; see Ashworth, J. and Miller, R. (1996), '*SE Sleuths on the Trail of Big Insider Dealing Rings*', *The Times*, 9/9/96.

97 In the United States the number of secondary insiders, in other words those who have gained price sensitive information through another party, being prosecuted has increased. Such insiders have ranged from printers to psychotherapists; see *United States v. Willis* [1990] 737 F. Supp. 269 (SDNY) and Corrigan, G. (1996), '*The America: Insider Trading Cases Increasing: The Odds are High that Dirty Dealers will be Caught*', *The Financial Times*, 20/9/96.

direct or indirect trading but has also attracted the attention of organised criminal fraternities.⁹⁸

In recent years, with the advent of many high profile cases involving fraud⁹⁹ and its investigation one may assume that this problem rather than diminishing has become more prevalent.¹⁰⁰ Indeed, the fact that most of these cases have resulted in most of the defendants being acquitted¹⁰¹ or receiving light sentences and/or fines,¹⁰² suggests that the use of the criminal law¹⁰³ may be inappropriate,¹⁰⁴ are in fact right

98 Rider, B.A.K. and Ffrench, H.L. (1979) noted:

"... Perhaps even more disturbing is the evidence that organised crime has been active in recent years in the field of securities frauds. There have been suspected Mafia involvement with stock market manipulation and insider dealing, and in the Far East there are many indications that Chinese 'triads' have been similarly attracted to the securities markets of Hong Kong and the Philippines. The employment of conventional investigatory techniques has perhaps not surprisingly provided inadequate..."

; *The Regulating of Insider Trading*, (1979), at 419. Instances of organised gangs infiltrating the market place are uncommon even today. In 1992, for example, the Sokaiya, the white collar crime branch of the yakuza, was investigated by the National Criminal Intelligence Service; *The Guardian*, 28th September 1992. Also see Rider, B.A.K. (1989), '*Policing the City - A Crime of Our Time?*', Current Legal Problems, at 86 and generally Rider, B.A.K. (1993), *Organised Crime in Britain*, Home Affairs Committee, London: HMSO. In addition, see '*Crime and Fraud in a New League*', (1994) *Business Insurance*, Vol. 28, No. 53, at 39 *et seq.*

99 For example, the United Kingdom has had market scandals involving *Barlow Clowes*, *Blue Arrow*, and *Guinness*. While, of even greater magnitude, the United States has encountered *Ivan Boesky*, *Michael Milken* and *Dennis Levine*. Interestingly, large fraud cases as well as generating formal reports have also spawned readable accounts of what such affairs; see, for example, Lever, L. (1992), *The Barlow Clowes Affair*, London: Macmillan *cf.* Ziman, M. and Hoffman, J. (1995), *DTI Report, James Ferguson Holdings Plc Barlow Clowes Gilt Managers Limited – Investigations Under Section 432(2) and Section 442 of the Companies Act 1985*, London, HMSO.

100 For instance, it has been generally observed that since 1981 City fraud has risen by 42%, and has risen ever since; Chapman, C. (1986), '*How the New Stock Exchange Works*', London: Macmillan, at 145.

101 Barnett, E. (1996), '*Seeboard Man Cleared of Inside Deals Charge*', *The Observer*, 8/12/96.

102 *Post*, Chapter 6; Ashe, T.M. and Counsell, L. (1993), *supra*, note 67, at 179; Fearnley, K. (1990), '*The Victimless Crime Becomes the Convictionless Crime*', *Financial Weekly*, 23/2 - 1/3/90, at 14; Farrelly, A. (1999), '*New Insider Trading Law "Toothless"*', *The Observer* 7/11/99 and *House of Commons Trade and Industry Committee* (1990), *supra*, note 32, at xxx.

103 Hadden, T. (1983), *supra*, note 64, at 500; Naylor, J.M. (1990(a)), '*The Use of Criminal Sanctions by the United Kingdom and United States Authorities for Insider Trading: How Can the Two Systems Learn from Each Other?*', (1990) 11(5) *Company Lawyer*, at 58; Rider, B.A.K. (1990), '*Policing the International Financial Markets: An English Perspective*',

for the purpose for which they were designed to serve; for only when the correct tools are present and used in their most productive manner can any desirable result be achieved.

Brooklyn Journal of International Law, at 179 *et seq.*; McVea, H. (1996), '*Fashioning a System of Civil Penalties for Insider Dealing: Section 61 and 62 of the Financial Services Act 1986*', Journal of Business Law, at 344; and Rider, B.A.K. (1995), '*Civilising the Law - The Use of Civil and Administrative Proceedings to Enforce Financial Service Law*', Journal of Financial Crime, Vol. 3, No. 1, at 11.

104 Levi, M. (1993), *supra*, note 59, at 82:

"... It is generally assumed that the regulatory system will work a great deal quicker than the criminal justice one....Tribunals normally do not operate any hearsay rules, and admit documents readily without the need formally to 'prove' their contents..."

Ibid., at 85:

"... The fact that U.K. (insider dealing) prosecutions have produced nothing of an even remotely comparable status may show that the U.K. system is badly designed, that such offences are inherently unprosecutable, or that no such elite figures are involved in Britain..."

, and Rider, B.A.K. (1996), '*Day of the Civil Sanction?*', Company Lawyer, Vol. 17, No. 9, at 257:

"... the sledgehammer of the criminal law cannot be expected to deliver the sort of results that are needed for protecting confidence in the integrity and efficiency of the capital markets..."

1.3.3. *A Time for Change - The American Way?*

Public concern is often an important factor in determining legal changes. Therefore if public confidence in the system is at a low ebb, a political drive for change is likely. Unfortunately, this is not the only requirement needed for change to come about. Adequate resource is vital. All too often though, it has been argued that both these features are lacking in this country. As *Lord Justice Roskill*, who was appointed by the former Government to review the prosecution of fraud, noted:

*“... the public no longer believes that the legal system in England and Wales is capable of bringing the perpetrators of serious frauds expeditiously and effectively to book. The overwhelming weight of the evidence laid before us suggests that the public is right.”*¹⁰⁵

Given the facts it may be perceived that the enforcement procedures used in regulating insider dealing and manipulative practices have failed to achieve the objectives set out in the previous decade.¹⁰⁶ This was to ensure:

*“... that the financial services sector is, and is seen to be, a ‘clean’ place to do business.”*¹⁰⁷

The apparent failure to achieve this goal has led to the analogy that capital markets have become little more than casinos.¹⁰⁸ Indeed, given the amount of criticism that has been levelled it is surprising that recent legislative changes have

¹⁰⁵ Roskill (1986), Committee Report on Serious and Complex Fraud, London: HMSO, at paragraph 1.

¹⁰⁶ See generally *Review of Investor Protection - A Discussion Document*, (1982) and *Review of Investor Protection*, (1984), Report Part 1, Cmnd. 9125.

¹⁰⁷ *Supra*, note 72, Cmnd. 9432, at paragraph 3.1. This view has been made on a number of previous occasions; Mr B. George, *Companies Bill*, 22/10/79, at column 96:

“... The City not only has to be clean but has to show itself to be perfectly clean...”

¹⁰⁸ Gower, L.C.B. (1988), *supra*, note 95, at 1.

failed to strengthen perceived weaknesses in tackling these types of offences.¹⁰⁹ Although alternative provisions exist for a civil suit to be brought¹¹⁰ they are typically expensive, evidentially complex and time consuming. Consequently they are rarely utilised by the people who need them most.¹¹¹

Over the past decade and a half the United States has had far more success in investigating and prosecuting insider and manipulative activities than the United Kingdom.¹¹² This success cannot be put down to a single factor but the United States has developed a variety of novel approaches to deal with and deter market frauds. It is far more flexible in its approach than the United Kingdom, a trait that typifies many of the laws and bodies used in the fight against these offences and accounts for many of its successes.

Although Constitutional,¹¹³ cultural¹¹⁴ and structural¹¹⁵ differences now clearly exist between the United States and the United Kingdom this was not always

¹⁰⁹ *Post*, chapter's three - five.

¹¹⁰ Sections 61 and 62 *FSA* and chapter five.

¹¹¹ *Post*, chapter's three and five.

¹¹² See generally 'Criminal Prosecutions under the Federal Securities Laws and Related Statutes - The Nature and Development of SEC Criminal Cases', (1971) 39 *George Washington Law Review*, at 901; cf. Markham, K. (1987), who observed:

"...cases involving manipulative claims require many years to reach trial and tremendous expense to investigate. Most CEA and CFTC manipulation cases have lasted eight years or more, and have consumed thousands of man hours of the agencies' scarce resources. Private lawsuits have had no better results. This, of course, discourages the filing of manipulation cases and virtually eliminates their deterrent effect..."

; *Commodities, Regulation, Fraud, Manipulation and other Claims*, Boston: Little, Brown and Co, at paragraph 15.02.

¹¹³ In the United States laws are classified as either being State or Federal. However, for the purposes of this thesis will only be confined in examining only federal or 'blue-sky' laws.

¹¹⁴ Cultural developments are often influenced by historic, economic and policy developments. Therefore, while such developments offer other jurisdictions jurisprudential understanding into such a particular area it is often impossible to attach their laws to other jurisdictions due to such individualism. For a further discussion on the limitations of comparative analysis see Rider, B.A.K. (1988), 'Policing the City-Combating Fraud and Other Abuses in the Corporate Securities Industry', *Current Legal Problems*, at 51, who comments:

so. Both have at various times encountered similar endemically proportioned share scandals,¹¹⁶ have adopted similar attitudes to manipulative practices¹¹⁷ and have recognised the need for a investor protection.¹¹⁸

“... Sadly, there are many examples throughout the world where inappropriate legislation or regulatory models have been simply ‘borrowed’ from other countries without due regard to the special and peculiar local conditions...”

- 115 This refers to the structural differences that exist in relation to how both jurisdictions combine commercial and investment banking activities. For a perspective on the United Kingdom’s position pre- and post- ‘Big Bang’; see generally Kay, M. (1986), *The Big Bang*, London: Macmillan. For comment on the *Glass Steagall Act* in the United States see Kelly, L. (1985), ‘*Legislative History of the Glass Steagall Act*’, in Walter, P. (ed.), *Deregulating Wall Street*, Boston: Little, Brown and Co (1985). Although it can be noted that there is evidence that this wall of separation between investment and commercial activities by banks is eroding; see ‘*American Banking: With a Wimper*’, *The Economist*, 2/11/96; Ianni, I. (1983), ‘*Security under the Glass Steagall Act and the Federal Securities Acts of 1933 and 1934: The Direction of the Supreme Court’s Analysis*’, *Banking Law Journal*, Vol. 100, at 100. In addition it has been noted that the *Securities Act 1933* was drafted on the *English Companies Act 1929*; Landis, F. (1959-60), ‘*The Legislative History of the Securities Act of 1933*’, *George Washington Law Review*, Vol. 28, at 34.
- 116 Bearle, H. (1947), *Regulation of Stock Market Manipulation*, *Yale Law Journal*, Vol. 56, at 508; and the *Memorandum of the Securities and Exchange Commission in support of Insider Trading Sanctions Act of 1984*, (1984), H.R., Rep. No. 355, 99th Cong., 2d, Sess. 21.
- 117 Manne, H. (1966), *Insider Trading and the Stock Market*, New York: The Free Press, at 1.
- 118 In *Ernst and Ernst v. Hochfelder* [1976] 425 U.S., 195, the Supreme Court stated that the *Securities Act 1933* was:

“...to protect investors against fraud and... to promote ethical standards of honesty and fair dealing...”

1.3.4. *The Use of the Criminal Law - Antiquated Relic?*

The United States and United Kingdom can be seen to have a variety of sanctioning powers at their disposal to use against insider dealing and manipulative practices.¹¹⁹ There is clear evidence that the United States has greater impetus not only to utilise those rules of law which seek to either punish or enforce compliance but also the political will to do so.¹²⁰ That said, most forms of sanction could be viewed as falling into one of two broad categories. They may be either inherent in their form (a person who contravenes a regulatory standard commits a punishable offence) or ancillary to it (any unauthorised person who enters into a transaction with another will commit a punishable offence). Most regulation is, therefore, underpinned by the use of the criminal law.¹²¹

Yet, the identification of regulation with the criminal law has nevertheless proven problematic.¹²² Any investigation that undertakes an international dimension will invariably find it harder to enforce criminal sanctions because of the different legal constraints imposed by different jurisdictions. Regulatory offences are also not easily reconciled with the popular notion of criminal activity. Indeed, it is commonly espoused by criminologists that such offences do not correlate with the possession of moral delinquency as their basis.¹²³ Although a clear distinction between what is *mala in se* ('wrongful in itself' and therefore 'criminal' conduct) and *mala prohibita*,

¹¹⁹ *Post*, chapter five.

¹²⁰ Rider, B.A.K. and Ashe, T.M. (1993), *supra*, note 10, at 88 *et seq.*

¹²¹ English and American criminal law have been viewed as having similar aims. Smith, J.C. and Hogan, B. (1992), refer to the American Law Institute's *Model Penal Code* when defining what the criminal law is to achieve; *Criminal Law*, London: Butterworths, at 17.

¹²² Williams, I. (1955), 'The Definition of Crime', *Current Legal Problems*, at 107; Kadish, T. (1963), 'Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulation', *University of Chicago Law Review*, Vol. 30, at 432; and Ball, H. and Friedman, L. (1965), 'The Use of Criminal Sanctions in the Enforcement of Economic Legislation: A Sociological View', *Stanford Law Review*, Vol. 17, at 197.

¹²³ Cohen, E. (1981), 'Footprints on the Sand: A Further Report on Criminology and the Sociology of Deviance in Britain' in Fitzgerald, E. (ed.) (1981), *Crime and Society*, London: Macmillan, at chapter thirteen.

(wrongful in the eyes of the law only)¹²⁴ exists, many in the City believe that insider dealing and market manipulation belong in the latter rather than former category.¹²⁵

While the moral basis of mainstream criminal law is reflected in the requirements that the prosecution must prove not only the wrongful act (*actus reus*) but also some degree of mental responsibility (*mens rea*), this does not always suit offences related to securities dealing.¹²⁶ The perception is that there is often a very thin, if not blurred, line between activities that may amount to being criminal and/or acceptable market practice.¹²⁷

Generally, it may be surmised that the criminal law is neither appropriate nor successful in bringing all those who commit regulatory offences effectively to book.¹²⁸ Regulatory offences, some judges believe are ‘*not criminal in any real sense*’¹²⁹ or even ‘*quasi-criminal*’.¹³⁰ It has been stated that:

“... [a]lthough enforced as penal laws through the utilisation of the machinery of the criminal law, the(se) offences are in substance of a civil nature and might well be regarded as a branch of administrative law to which traditional principles of criminal law have but limited application...”¹³¹

124 Wells, C. (1993), *Corporations and Criminal Responsibility*, Oxford: Clarendon Press, at 7 *et seq.*

125 Ashe, T.M. and Counsell, L. (1993), ‘*Insider Trading*’, at 198.

126 Clarke, M. (1990), *Business Crime: Its Nature and Control*, at 16 *et seq.*

127 *Post*, chapter four.

128 ‘*A Policeman’s Lot...*’, (1994) *Company Lawyer*, Vol. 15, No. 8, at 226. Also see Clarke, M. (1987) ‘*Prosecutorial and Administrative Strategies to Control Business Crime*’, in Shearing, C. and Stenning, P. (Eds), *Private Policing*, London: Sage, at 273 *et seq.*

129 *Sherras v. De Rutzen* [1895] 1 QB, at 922, *per Wright J.*; see also *Provincial Motor Cab Company v. Dunning* [1909] 2 KB, at 602, *per Lord Alverstone C.J.*

130 *Pearks, Gutson and Tee v. Ward* [1902] 2 KB, at 11, *per Channell J.*

131 *Dickson J. in R v. City of Sault Ste. Marie* [1978] 40 CCC (2d), at 357. See, to similar effect, *Lord Scarman in Wings Ltd. v. Ellis* [1985] AC, at 293.

Some commentators argue that the use of the language and the processes of traditional criminal law for regulatory purposes devalues their significance in relation to mainstream crime.¹³² Others hold that regulation is not morally neutral and that it is symbolically and instrumentally valuable to stigmatise areas of it as genuinely ‘criminal’.¹³³

Given the above arguments it is not surprising to find that support for the use of the civil law¹³⁴ to enforce compliance has grown. While the use of this law to enforce compliance is not a new idea its popularity in the United Kingdom, at least, to achieve this aim has not drawn significant attention from Parliament although other members of the English legal system can be seen favour in utilising it. *Rider*, for instance, suggests:

*“... To the extent that such [civil] procedures do provide compensation for those who have been harmed by the abuse in questioning and, thus, at least part of the wrongdoer's illicit profit has been removed, those concerned with policing the markets should be well-disposed to private suits. Indeed, it is hard to see why such should not be facilitated and assisted in appropriate circumstances, and the courts have certainly not opposed this.”*¹³⁵

¹³² Williams, I. (1955), *supra*, note 122, at 114 *et seq.*; and Kadish, T. (1963), *supra*, note 122, at 443 *et seq.*

¹³³ Wells, C. (1993), *supra*, note 124, at 29 *et seq.*

¹³⁴ ‘*Fraud and the Civil Law: Further Development*’, (1997) *Company Lawyer*, Vol. 18, No. 1, at 1 and chapter five.

¹³⁵ Rider, B.A.K. (1995), ‘*Civilising the Law-The Use of Civil and Administrative Proceedings to Enforce Financial Service Law*’, *Journal of Financial Crime*, Vol. 3, No. 1, at 24 and Rider, B.A.K. (1998), ‘*Civilising the Criminal Law*’, *Company Lawyer*, Vol. 19, No. 6, at 161.

1.3.5. The Significance of this Thesis

The purpose of this research is not only to evaluate, through comparative analysis,¹³⁶ those enforcement mechanisms presently used in the United Kingdom¹³⁷ with those of the United States,¹³⁸ but more importantly to assess whether anything can be gained from an examination of the use of those legal means which are *not significantly utilised* in the United Kingdom, yet are used to great effect in the United States. Thus, emphasis will be placed on examining the role of *independent tribunals*¹³⁹ and the use of the *civil law*¹⁴⁰ as opposed to the criminal justice system

¹³⁶ The successful use of the civil law in the United States as an enforcement mechanism against unwarranted market practices has led to the assertion being made in the United Kingdom that if one is to achieve the same success it is surely essential to 'mimic' that system. This issue was broached by Gower, L.C.B. (1984):

"... Some respondents to the Discussion Document ... suggest that all that is needed to solve the enforcement problem is expressly to provide for civil remedies and to make some minor adjustments.... While I agree with this view to the extent of suggesting that statutory provisions and regulations intended for the protection of investors should provided a civil remedy.... I do not share the optimism that this would solve the enforcement problems..."

; *Review of Investor Protection, Report: Part 1*, *supra*, note 79, at paragraph 10.29. See also Alistair Darling, *Annual Labour Conference*, 8/5/96:

"....it is not possible, nor is it desirable to import other country's solutions to the regulatory problems we see..."

Cf. Kiralfy, A. (1948-49), 'The Persuasive Authority of American Rulings in England', *Tulane Law Review*, Vol. 23, at 209; on the individualism of jurisdictional rulings.

¹³⁷ *"... Law enforcement is a complex topic, to which, as a topic of study and discussion, we give far too little attention..."*

; Rider, B.A.K. (1996), 'Day of the Civil Sanction?', *Company Lawyer*, Vol. 17, No. 9, at 257.

¹³⁸ While the value of comparative analysis has often been over-looked it can play an appreciative role in areas of law where there is a distinct *nexus* between opposing jurisdictions.

"... There seems to be a widespread feeling both in Britain and America that it (comparative analysis) has ceased to be fruitful because of the rapid and independent growth of case law and legislation in the two countries...(T)his feeling is misguided; that in reality each country can still learn much from the other. This thesis is hardly surprising, for both legal systems deal with similar problems resulting from economic and social conditions which are still largely the same..."

; Gower, L.C.B. (1969), 'Contrasts between British and American Corporation Law', *Harvard Law Review*, Vol. 69, at 1369-70.

¹³⁹ Llewellyn-Jones Q.C., 'What of the Future?', *New Law Journal*, 19th July 1996, at 1059, who suggests that:

in investigating these types of practices as a more appropriate and effective means of redress in such instances in conjunction with assessing the feasibility of a SEC-like structure being introduced¹⁴¹ and radical changes to the way in which serious securities fraud cases should be tried.

“... The insider dealer could probably be more successfully investigated by an independent tribunal (provided there is trust in the system) than prosecuted...”

- ¹⁴⁰ Traditionally, in the United Kingdom insider dealing and manipulative practices have always been viewed as criminal offences. However, this attitude has been questioned:

“... Under a criminal system, the hurdle to be cleared in mounting a successful prosecution through the courts is understandingly high....It seems to me that there are lessons we can learn from those countries which have chosen to adopt non criminal remedies as part of their overall approach to dealing with cases of market abuse.

This is not to say that we should decriminalise market abuse. Not at all. There will always be cases which, on any view, merit criminal prosecution. But I do think that we should consider seriously the possibility of introducing civil powers, whether exercised administratively or through the courts.

This would enable the regulators to deal with all of those cases which do not merit criminal prosecution. This might include the use of civil penalties, disgorgement of profits and restitution to the victims of market abuse...” (emphasis added)

; Large, A. (1996), Chairman of the SIB, speech given to the CSFI/Cityforum Conference, Glaziers' Hall, London, 3rd July 1996.

- ¹⁴¹ Trapp, S. (1996), ‘We Need a U.S.-Style Crackdown on Financial Crime’, *The Independent*, 6/11/96.

1.4. Summary

The City is undoubtedly one of the most important financial institutions in the world, assisting national economic stability whilst providing a vehicle for individual investor's to safeguard their futures. However, as can be seen from a consideration of the last decade, when City fraud was discovered to be rapidly growing, this reliance on the City can lead to a lack of proper market regulation. With the implementation of new, more complicated forms of securities and the reliance on information technology, this situation has been exacerbated even further with potentially new effective forms of market fraud being developed and used. Yet, investigations always seem to be one step behind the fraudster and even when he or she is caught, there is nearly always a failure in prosecuting them. So why has the system failed?

In this chapter the outlines of the major problems with regulatory enforcement in the United Kingdom has been uncovered. Briefly, these relate to:

- (i) the difficulties in detecting insider dealing and market manipulative crimes;
- (ii) the inadequacies in resources and the attitude of those given the task of investigating and prosecuting such fraudsters;¹⁴²
- (iii) the inadequacies found in the relevant legislation and the problems associated with the burden of proof and trial by jury through the use of the criminal law; and
- (iv) jurisdictional difficulties.

¹⁴² Harding, K. (1990), '*An Attitude Problem to Fraud Resistant Systems*', *Accountancy Age*, 26/6/90, at 10.

Chapter Two

Justifying Market Regulation

Overview

The general acceptance that today's securities markets need to be regulated has facilitated the implementation of the essential elements of investor confidence and market integrity.¹ Yet given that genuine counter-arguments exist relating to the restrictive nature regulation has on competition, can such an assertion be wholly justified?² The purpose of this chapter is, therefore, to not only determine the appropriateness of current regulatory measures but also to determine whether it should be applied to insider dealing and market manipulation. This is achieved by examining the common theoretical aspects underpinning the regulation of the financial markets of the United Kingdom and United States to assess whether regulation is, indeed, a justifiable trait in governing market activities.

¹ *House of Commons Parliamentary Debates, Financial Services Bill*, 14/1/86, at column 939 and Pit, T. and Hardinson, I. (1992), 'Games without Frontiers: Trends in the International Response to Insider Trading', *Law and Contemporary Problems*, Vol. 55, at 200 et seq..

² Large, A. (1993), 'Financial Services Regulation: Making the Two Tier System Work', at paragraph 1.16. Also see *Commons Parliamentary Debates, Standing Committee 'D'*, 29/6/89, at columns 598-599 and Fox, D. (1992) 'Insider Trading in a Globalizing Market: Who Should Regulate What?', *Law and Contemporary Problems*, Vol. 55, at 263 et seq..

2.1. Common Theoretical and Practical Aspects of Market Regulation

Given that the large number of conflicting variables exist which have collectively had a profound effect on overall behavioural traits, defining what exactly amounts to regulation has seldom proven easy. Thus, it is not surprising that a large aggregate of varied definitions has evolved epitomising individual theories as to its general functionality. If one looks to *Ogus*, for instance, he argues that most regulatory systems are commonly styled on what can be perceived as ‘*command-and-control*’ principles seeking to dictate albeit in a flexible manner how markets should behave and react.³ By contrast, *Hawkins* believes regulatory measures are developed to enhance the public good.⁴ *Rider and French* also generally follow in this vein arguing that financial regulation is essential for the predisposition of every member of the public.⁵ Yet while the majority of generated definitions have tended to concentrate on particular aspects in explaining how and why regulation is needed very few have collectively sought to explain *why* they have evolved in the manner they have. The research carried out by *Mitnick* has sought to rectify this by offering the general hypothesis that regulatory systems evolve to rectify past and present abuses.⁶ *Stenning*⁷ and *Mansfield*⁸ can also be perceived to have built upon this premise by arguing that regulation is primarily applied to alter the demeanour (which has become unacceptable) of those who participate in market activities by the use of rules so that

³ Ogus, A. (1994), *Regulation-Legal Form and Economic Theory*, Oxford: Clarendon Press, at 79.

⁴ Hawkins, K. (1984), *Environment and Enforcement: Regulation and the Social Definition of Pollution*, Oxford: Clarendon Press, at 16 *et seq.*. The possibility exists that when a party enters into a bargaining position under extreme duress, an economic justification exists for regulation; Burrows, E. (1995), ‘*Contract Discipline: In Search of Principles in the Control of Contracting Power*’, *European Journal of law and Economics*, Vol. 2, at 134 *et seq.*.

⁵ Rider, B.A.K. and French, H.L. (1979), *The Regulation of Insider Trading*, London: Macmillan, at 6 *et seq.*.

⁶ Mitnick, B.M. (1980), *The Political Economy of Regulation*, New York: Columbia University Press, at 204 *et seq.*.

⁷ Stenning, P.C., Shearing, C.D., Addario, S.M. and Cordon, M.G. (1990), ‘*Controlling Interests: Two Conceptions of Order in Regulating a Financial Market*’, in Friedland, M.L. (ed.) (1992), *Securing Compliance: Seven Case Studies*, Toronto: University of Toronto Press, at 102 *et seq.*.

⁸ Mansfield, E. (1982), *Microeconomics: Theory and Application*, New York: Norton, at 20.

future behavioural traits are change for the better. Fundamentally, the use of rules can be perceived to have three significant purposes. While some can be directed towards crucial matters affecting the structure of the market itself, others are either concerned with the operational aspects of the market or seek to deter fraudulent or manipulative trading practices.⁹ Hence, rules can be viewed as being used to permit, prescribe or prohibit specific forms of conduct.¹⁰ Another common feature is that not all of these rules are statutory in nature or enforced by law. For example, where take-overs are involved, self-regulation prevails. It is argued that in these instances this form of regulation has proven more effective than statutory measures.¹¹ Yet, given that most Western financial markets employ a mixture of statutory as well as non-statutory regulation each has not only positive but also negative attributes.

There are a number of distinct advantages associated with self-regulation. It is said, for instance, that it is capable of generating and maintaining higher standards' than is attainable via statutory intervention because obligations are usually voluntary rather than rigidly imposed.¹² These can be expressed as a broad mixture of general rules, subsidiary principles and various sanctions, rather than detailed and often

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- ⁹ See generally Levi, M. (1987), *Regulating Fraud: White Collar Crime and the Criminal Process*, London: Tavistock; Clarke, M. (1986), *Regulating the City: Competition, Scandal and Reform*, Milton Keynes: Open University and Clarke, M. (1987), 'Prosecutorial and Administrative Strategies in the Control of Business Crime: Private and Public Policing' in Shearing, C. and Stenning, M. (eds.) (1987), *Private Policing*, London: Sage Publications.
- ¹⁰ Rules that permit certain conduct can be illustrated by those that allow stabilising activities, those that are prescriptive by the minimum capital rule and prohibitory by those that outlaw market abuse such as insider dealing or market manipulation.
- ¹¹ For example, before 1980 the Take-over Panel was as successful as any other regulatory body in controlling abusive practices; Rider, B.A.K. and Ffrench, H.L. (1979), *supra*, note 5, at chapter six. Indeed, much praise has been made of the flexible way the panel operates; Calcutt, J. (1990) 'Company Law Lecture – the Work of the Takeover Panel', *Company Lawyer*, Vol. 11, at 206 and Tridimas, T. (1991), 'Self-Regulation and Investor Protection in the United Kingdom: the Take-Over Panel and the Market for Corporate Control', *Civil Journal Quarterly*, Vol. 10, at 26 *et seq.* Presumably then, self-regulation applies when, in the given circumstances, government activity would be unjustifiable; Black, J. (1996), 'Constitutionalising Self-Regulation', *Modern Law Review*, Vol. 59, at 27.
- ¹² Rider, B.A.K. and Hew, E.J. (1977), 'The Regulation of Corporate and Securities Law in Britain – The Beginning of the Real Debate', *Malaya Law Review*, Vol. 1, No 19, at 159 *et seq.*

complex laws, which firms are expected to strictly comply with.¹³ Self-regulation can also be seen to offer flexibility in the application of rules, keeping pace with activities that previously were lawful but now are not.¹⁴ Systems that rely on statutory regulation can also lead to any conduct being regarded as permissible so long as it satisfies the legal requirements.¹⁵ The adaptability of self-regulation means that rules can be changed quickly and less formally than statutory regulation and consequentially can be directly applied to individual cases in a pragmatic manner.¹⁶ Self-regulation is also less likely to be challenged by the courts and is therefore less conceivable that it will be utilised to form the testing ground for potential litigation.¹⁷ Indeed, the courts have generally observed that:

“... [they] will not second guess the informed judgement of responsible regulators steeped in knowledge of their particular market.”¹⁸

However, it is questionable whether statutory regulation verily possesses some of the disadvantages often expressed, for self regulation can, itself, be seen to have a number of inherent weaknesses. Self-regulation is thus only practicable where regulators control benefits on the basis of which firms may be either induced or compelled to submit to regulation. To be an effective substitute for legal coercion, the benefits offered, or the denial of which is threatened, must be exclusive. In other

¹³ Fisse, B. and Braithwaite, J. (1993), *Corporations, Crime and Accountability*, Cambridge: Cambridge University Press, at 164.

¹⁴ *Cabinet Office and Treasury Report, Non Departmental Public Bodies: A Guide for Departments*, (1985), at paragraph 5.8 and *Wilson Report on the Review of the Functioning of Financial Institutions*, (1980), Cmnd. 7937, Second Stage Evidence, Panel on Take-overs and Mergers, London: HMSO; Morse, G. (1991), ‘*The City Code on Takeovers and Mergers – Self Regulation or Self Protection*’, *Journal of Business Law*, at 512 and Karmel, A. (1988), ‘*Securities Industry Regulation – Tested by the Crash*’, *Washington and Lee Law Review*, Vol. 45, at 1306 *et seq.*

¹⁵ *Op. cit.*, at paragraph 23.

¹⁶ Braithwaite, J. and Fisse, B. (1987), ‘*Self-Regulation and the Control of Corporate Crime*’, in Shearing, C. and Stenning, P. (eds.) (1987), *supra*, note 9, at 221 *et seq.*

¹⁷ *Op. cit.*, at paragraph 70 *et seq.*

¹⁸ *R v. International Stock Exchange of the United Kingdom* [1993] 1 All ER 420, *per Bingham M.R.*

words, they must be unobtainable in any other way. Moreover, they must exceed the costs entailed by submission, otherwise firms may simply decline to submit; and the benefits must continue to exceed the costs, otherwise firms may simply defect.¹⁹ Regulators, however, seldom control benefits that meet such requirements. Consequently, the practical scope for self-regulation can thus be viewed as limited.

By contrast, statutory regulation can be universally applied as a matter of direct legal obligation. Firms have no choice but to submit to regulation, whether statutory or non-statutory, if they are to avoid the penalties for acting illegally. Using the threat of legal sanctions to force firms to submit to regulation may mean, however, that the advantages associated with non-statutory regulation are forgone: firms may exploit loopholes in the rules in preference to complying with their spirit; regulation may lag behind current practices; innovation may be stifled by the rigid and mechanistic application of the rules;²⁰ and regulators may find themselves untrammelled in questions of *vires*. Thus, regulators have sought to make strenuous efforts to avoid these consequences. But if the only way in which regulation can be applied to firms is by invoking the threat of legal penalties, they may be unavoidable.

In the United Kingdom the ‘*old*’ regulatory regime was achieved by a mixture of:

“... statutory regulation monitored by self-regulatory organisations recognised by, and under the surveillance of, a self-standing Commission.” (See diagram overleaf);²¹

¹⁹ See generally Georgakopoulos, G. (1993), ‘*Insider Trading as a Transaction Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*’, Connecticut Law Review, Vol. 26, at 1 *et seq.*

²⁰ Gower, L.C.B. (1982), *Review of Investor Protection: A Discussion Document*, London: HMSO, at paragraph 6.02.

²¹ Gower, L.C.B. (1988), ‘*‘Big Bang’ and City Regulation*’, Modern Law Review, Vol. 51, at 6; Gower, L.C.B. (1984), *Review of Investor Protection Report: Part I*, Cmnd. 9215, at paragraph 2.03; Whittaker, M. (1990), ‘*Legal Techniques in City Regulation*’, Current Legal Problems, at 40. However, it has been argued that such a regime should more accurately be described as an example of ‘*co-regulation*’, that is to say, a system that combines self-regulation by industry members with monitoring and ratification by Government; Miller, M.H. (1985), ‘*Self-*

the latter being the long preferred form by the City²² due to the autonomy that can derived from it.²³

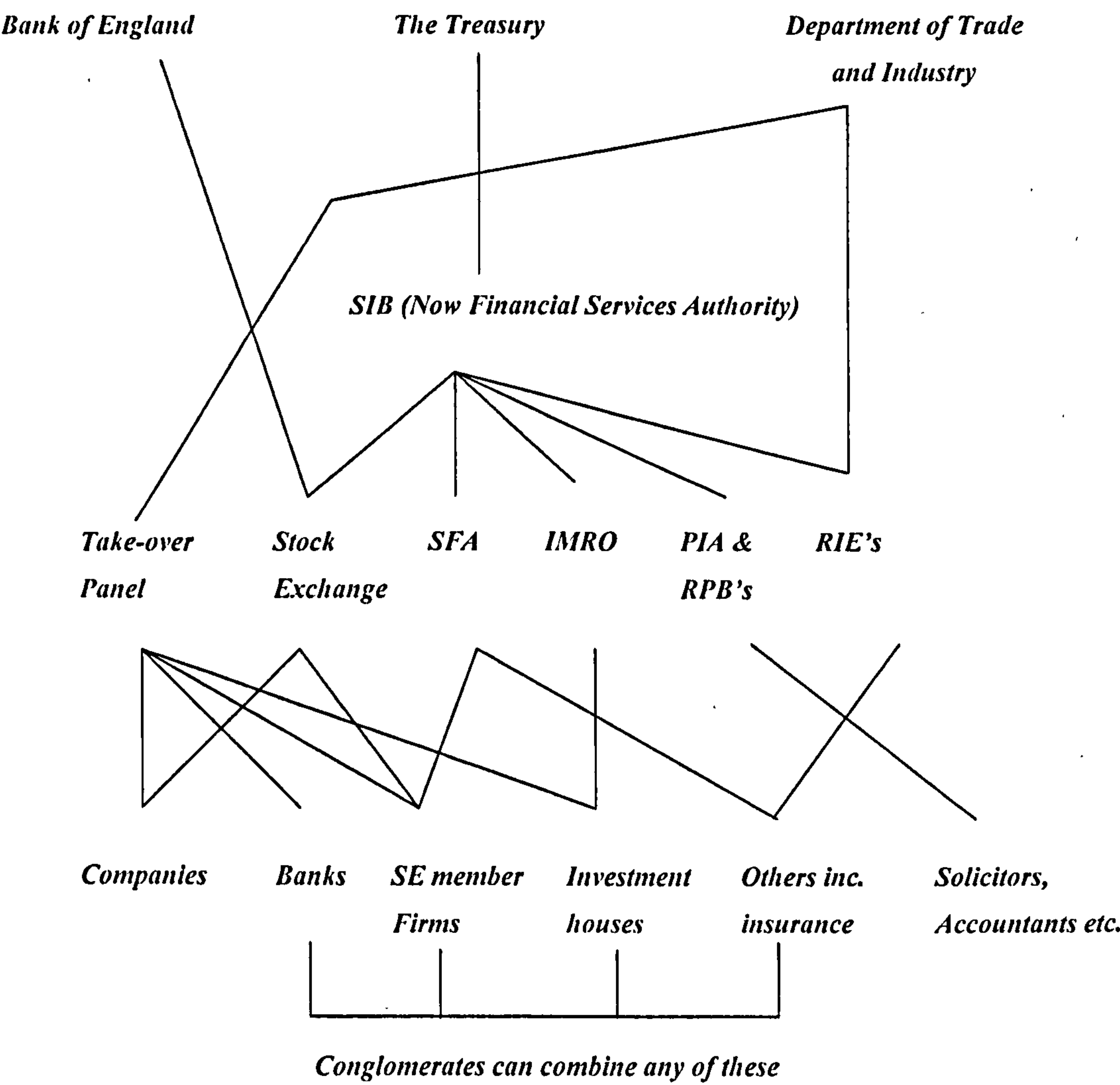


Fig. 2.1. Source:²⁴

Although self-regulation possesses a number of positive features such as:

Regulation of the Securities Markets: A Critical Examination, Washington and Lee Review, Vol. 42, at 859 *et seq.*

22 Page, A.C. and Ferguson, R.B. (1992), *Investor Protection*, London: Weidenfeld and Nicolson, at 82.

23 *Op. cit.*, at 83.

24 Adapted from *Gore-Browne on Companies*, (1993), chapter twelve, at paragraph 12.2.

*“... high standards, compliance with the spirit as well as the letter of the rules adaptability and flexibility in their formation and application, and speed and finality in regulatory decision-making...”*²⁵

all too often it has been criticised for allowing those in the City to manage their own affairs.²⁶ Indeed, given some of the observations made in subsequent chapters it is easy to comprehend why this belief of ‘*practitioner-based regulation*’ has developed and explains why the City has sought not to develop an alternative measures of regulation.²⁷

It can be observed that the *old* regulatory structure was largely made up of self-regulatory organisations (the ‘*SRO*’s’)²⁸ although these are accordingly recognised²⁹ by and under the ultimate surveillance of an overall regulator - the Securities and Investment Board (the ‘*SIB*’)³⁰ that is now known as the Financial Services Authority (the ‘*Authority*’). Each SRO has its own set of rules from which the basis of its

²⁵ *Op cit.*, at paragraph 12.3.

²⁶ Joel Joffe, ex-Deputy Chairman, Allied Dunbar typified this attitude when he stated:

“... how can you expect the same people who had been exploiting the public for decades to suddenly be put in charge of protecting them .. in principle it's like ...putting the mafia in charge of law enforcement in Italy...”

, *Naked City*, BBC 2, 6/11/96.

²⁷ *Post*, chapters three and five.

²⁸ Sections 7-21 *FSA* '86.

²⁹ Schedule 2 *FSA* '86.

³⁰ Rather than follow a regulatory system which derives its powers in detail from legislation the Government decided to:

“... set out principles and objectives enshrined in the statute... [so as] to allow a fair measure of discretion... by the designated agency, so that... an up-to-date and accurately targeted regulatory system [can be achieved]...”

; Mr A. Howarth, *Commons Parliamentary Debates, Standing Committee 'E'*, 28 January 1986, at column 39. See also Large, A. (1993), *Financial Services Regulation – Making the Two Tier System Work*, Securities and Investment Board Release, at paragraphs 8.2 *et seq.*

enforcement powers is derived.³¹ However, these are not statutory in scope but contractual in nature,³² although SRO's can request the *SIB* (now the *Authority*) to use its powers under *the Financial Services Act 1986* (the '*FSA '86*').³³

The *FSA '86* provides each *SRO* (of which there are three principally responsible for dealing with insider dealing and market manipulation³⁴) with powers to regulate their members carrying out investment business activities. In this respect, *SRO*'s can be perceived as the primary force of detection and enforcement against what may be regarded as market irregularities.³⁵ Likewise, boards consisting of representatives of their membership and outsiders representing the public interest govern them themselves. In addition, all *SRO*'s were accountable to the *SIB* (now *Authority*), whose primary responsibility it is to ensure that *SRO*'s complies with all *FSA '86* provisions.³⁶ Accordingly, it (the *Authority*) has the power to revoke all or part of any *SRO* if it fails to comply with those obligations imposed under the *FSA '86*.³⁷ However, in practice such provisions are rarely utilised and therefore only serves as a deterrent effect.³⁸ Realistically, if an *SRO* fails to comply with a provision under

31 See, for example, the *SFA's Conduct of Business Rulebook* Rule 5.46 and the *PIA's Rulebook* Rule 7.2.(4).

32 Such as the *SFA's Conduct of Business Rulebook*.

33 Section 61 and 62 *FSA '86*.

34 *Gore Browne* (1993), *supra*, note 24, at paragraph 12.31.

35 In determining what may or may not be unlawful practices is usually determined under statute, Rulebook reference or guidance notification; see, for example, '*Guidance on the Dissemination of Price Sensitive Information*', London Stock Exchange, July 1996 and '*Advice Under Section 206 of the Financial Services Act 1986: Equity-related Derivatives: Use of Inside Information*', The Securities and Investment Board Guidance Release, December 1996.

36 Large, A. (1996), '*Taylor the Rules to Reward the Good and Punish the Bad*', *The Times*, 24/8/96. Moreover, there have been calls for the Authority to have more extensive powers to deal with market abuse. This emphasises the growing feeling in the City that new laws are needed due to the inadequate results produced by the present ones; Parker, D. (1997), '*Davis Calls for New Powers*', *The Financial Times*, 13/10/97.

37 Section 11 *FSA*.

38 *Gore Browne* (1993), *supra*, at paragraph 12.4.1.

FSA '86 it is more likely that the *Authority* will order the *SRO* to alter its rules or apply to the courts to force the *SRO* into compliance.³⁹

Although the use of self-regulation was brought into effect to increase investor confidence the criticisms regarding this arrangement have been continuous.⁴⁰ Most have revolved around the premise that regulation is too fragmentary,⁴¹ resulting in a breakdown in communication between regulatory bodies,⁴² although lack of responsibility, compliance costs and investor confidence have all played a part.⁴³ This is not surprising, given the change of government radical, that reform has materialised.⁴⁴ Thus, the Bank of England is to lose its supervisory role to the *Authority*.⁴⁵ This is to be followed by the absorption of the specific *SRO*'s into the *Authority* so that it can carry out a more unified (and less confusing) approach in the regulation of banking, securities, and in due course, insurance trading which, it is argued, have now become blurred⁴⁶ (see diagram). Moreover, this apparent amalgamation should lead to the blending of '*distinctive cultures and approaches*'

39 Sections 12 and 13 *FSA '86*.

40 It has been commented upon that the United Kingdom has a long tradition of self-regulation; Baggott, F. (1989) '*Regulatory Reform in Britain: The Changing Face of self-Regulation*', *Public Administration*, Vol. 67, at 438 *et seq.*

41 *House of Commons Trade and Industry Committee, Third Report on Company Investigations*, (1990), at xxii and Mercer, A. (1993), '*Financial Services Update*', *Business Law Review*, at 75.

42 Mackay, A. (1992), '*IMRO Attacked for Maxwell Funds Failure*', *The Times*, 10/7/92; Bosworth-Davies, R. (1994), '*Powers Granted to the SIB under FSA 1986, section 59*', *Company Lawyer*, Vol. 15, No. 4, at 119. In particular, see '*How Many Regulators?*', (1996) *Company Lawyer*, Vol. 17, No. 2, at 34 and '*The Power of Fear*', (1993) *Company Lawyer*, Vol. 14, No. 1, at 2, for arguments regarding the suitability of the SIB as an enforcement agency.

43 Gowers, P. (1997), '*City Watchdog Urges Wide Reform: Proposals to Merge SIB and Self-Regulatory Bodies*', *The Financial Times*, 19/5/97 and Gowers, P. (1997), '*Planning Blight in the City*', *The Financial Times*, 20/5/97.

44 Sarker, R. (1998), '*Reform of the Financial Regulatory System*', *Company Lawyer*, Vol. 19, No.1, at 11 *et seq.*

45 Jones, E. and Northedge, B. (1997), '*Super Watchdog for City in New Shake-Up*', *The Daily Telegraph*, 21/5/97.

that in the past had caused problems with regulatory enforcement.⁴⁷ This should theoretically, at least, actively improve the general role of regulation through the prevention of turf wars, duplication and bureaucracy. Indeed, such reform reflects the underlying ideology to enact change in City practices that has been long been adopted as standard Labour policy.⁴⁸ The impact this move has had on the City has, not surprisingly, been ambivalent although for the most part sanguine.⁴⁹ Indeed, radical reform of the *FSA '86* has been promised to take effect from this year.⁵⁰

⁴⁶ City Comment, '*Hyperactive Labour's Blow to the Bank's Prestige*', *The Daily Telegraph*, 21/5/97.

⁴⁷ See generally Large, A. (1997) Report on '*Reform of the Financial Regulatory System*', Securities and Investment Board Release, 7/97 cf. Shrimpton, C. (1998), '*The Financial Services Authority*', *Practical Law for Companies*, Vol. 9, No. 9, at 14 *et seq.*; Martinson, P. (1999), '*City Regulation 'May Prove to be Ineffective'*', *The Financial Times*, 4/1/99; '*FSA Assumes Responsibility for Banking Supervision*', (1998) *Financial Services Brief*, Vol. 5, at 1 *et seq.*; Boleat, E. (1999), '*The New System of Financial Regulation: Part 2*', *London Markets Newsletter*, at 5 *et seq.* and Boleat, E. (1999), '*The New System of Financial Regulation: Part 3*', *London Markets Newsletter*, at 7 *et seq.*

⁴⁸ Brummer, A., Miller, R. and Smithers, S. (1997), '*Dynamic Brown Stuns City*', *The Guardian*, 21/5/97.

⁴⁹ Jones, E. and Northedge, B. (1997), *supra*, note 45.

⁵⁰ Miller, C. (1997), '*Darling Aims to Convert the City*', *The Times*, 21/5/97. Although note, Peston, R. and Eaglesham, D. (1998), '*FSA Faces Two Year Wait for Full Regulatory Powers. Parliamentary Backlog Delays Financial Services Reform Bill*', *The Financial Times*, 1/6/98.

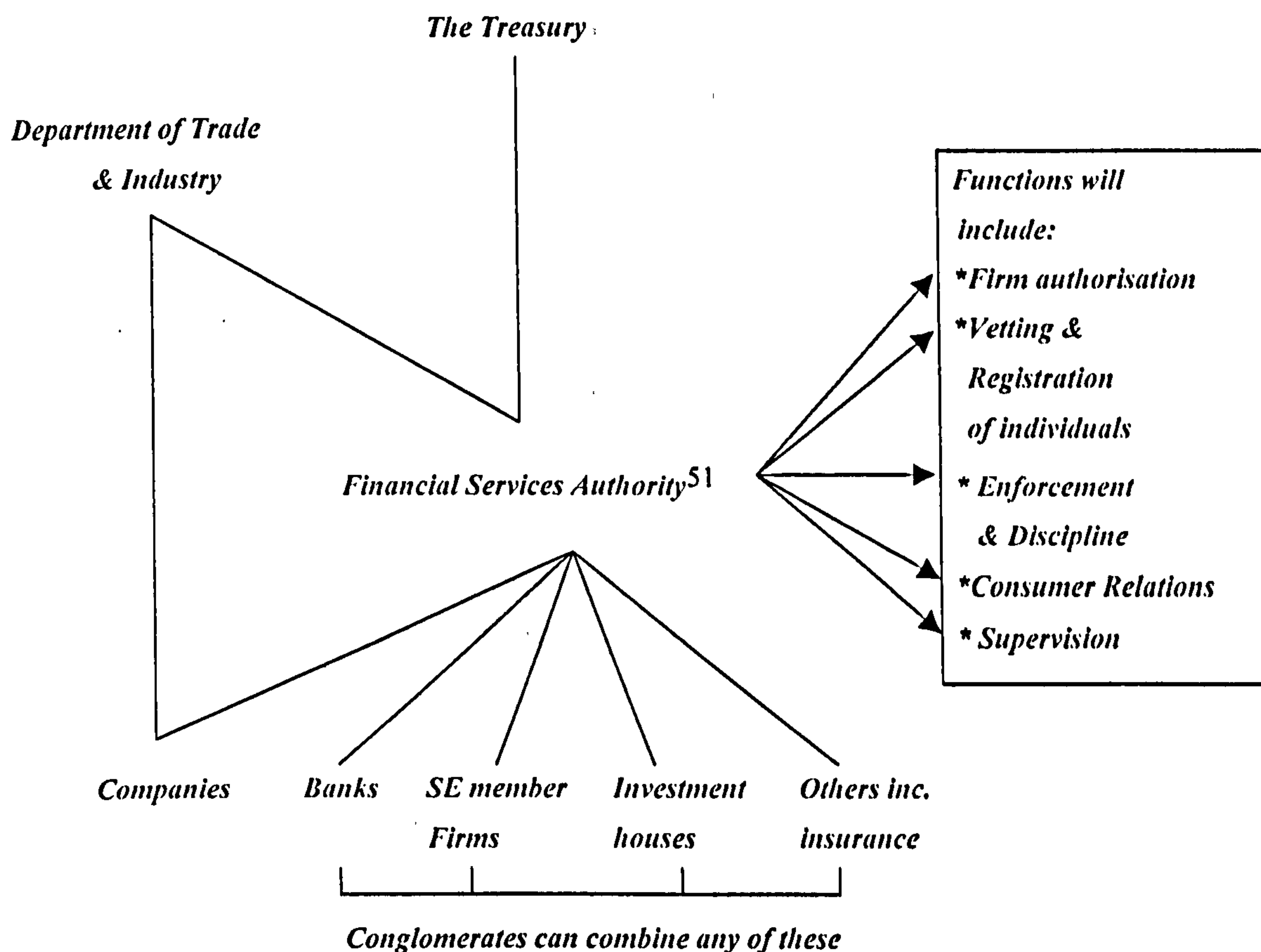


Fig. 2.2.

A common but misconceived notion is that there are no role for self-regulation in the United States. Like the United Kingdom, demand for regulation is carried out on both a formal regulatory and self-regulatory basis. This latter regime is achieved through the utilisation of the number of exchanges, such as the New York Stock Exchange ('NYSE'),⁵² the American Stock Exchange ('Amex'), the Over-The-Counter Market ('OTC') and the National Association of Securities Dealers ('NASD'). Like the Authority, the Securities and Exchange Commission (the 'SEC')⁵³ is charged with

⁵¹ The Securities and Investment Board became the 'Financial Services Authority' under the *Financial Services (Change of Name of Designated Agency) Rules 1997* on 28/10/97.

⁵² *House of Commons Trade and Industry Committee* (1990), *supra*, note 41, at 138.

⁵³ For a general overview of how the SEC has developed see generally Douglas, L. and Bates, A. (1933), 'The Federal Securities Act of 1933', *Yale Law Journal*, Vol. 43, at 171; Johnson, P. and Jackson, M. (1937), 'The SEC – Its Organisation and Functions Under the Securities Act of 1933', *Law and Contemporary Problems*, Vol. 4, at 3; Landis, E. (1959), 'The Legislative History of the Securities Act of 1933', *George Washington Law Review*, Vol. 28, at 29 and Cary, H. (1964), 'Administrative Agencies and the SEC', (1964) *Law and Contemporary Problems*, Vol. 29, at 653.

the function of exercising overall supervision of the markets and their regulation. Established in 1934, this non-partisan agency is unlike the Authority in that it has more extensive powers which not only extend to the formal regulating of *SRO*'s but also take-overs (see diagram).⁵⁴

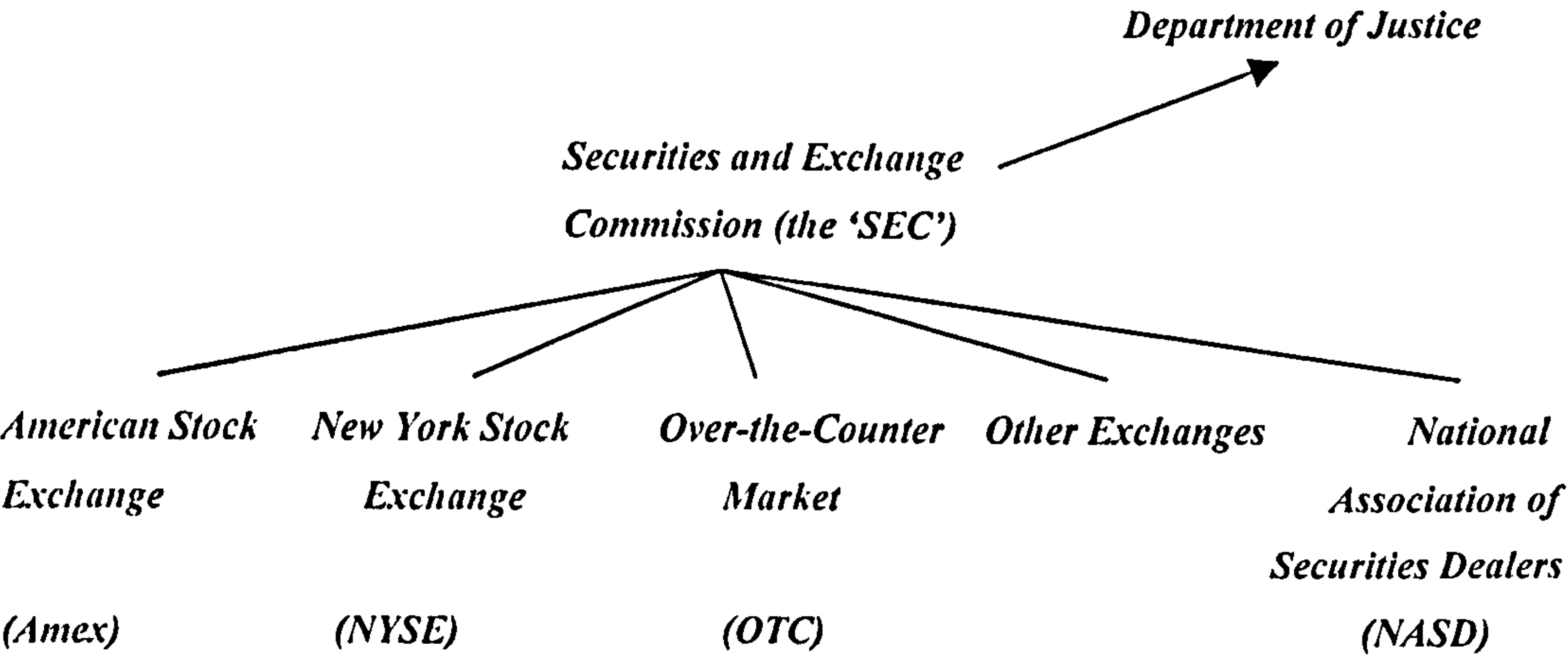


Fig. 2.3.

The *SEC* is one of the most important agencies in the United States and is able to command resources that are beyond the reach of the *Authority*. It possesses both quasi-legislative and quasi-judicial powers that are used to administer those federal securities laws granted under various securities *Acts*. For the purpose of this thesis only the *Securities Act of 1933* (the '*SA* ') and the *Securities Exchange Act of 1934* (the '*SEA*')⁵⁵ are directly applicable, although it can be acknowledged that others are highly relevant. Using the *SEA* in conjunction with other pieces of legislation, the *SEC* is empowered to deal with frauds connected with the manipulation and the purchase or sale of securities.⁵⁶

54 The original idea of Congress was that the SEC would act as an additional level of regulation to *SRO*'s; Jennings, K. (1964), '*Self-Regulation in the Securities Industry: the Role of the Securities and Exchange Commission*', *Law and Contemporary Problems*, Vol. 29, at 667 *et seq.*.

55 Burk, I. (1976), '*The Origins of Federal Securities Regulation: A Case Study in the Social Control of Finance*', *Social Forces*, Vol. 63, at 1010.

56 *Post*, chapter three.

Insider dealing and market manipulations are not only civil offences in the United States, as they may additionally attract criminal liability. Although unlike the United Kingdom only the most serious of these types of offences are pursued in the criminal courts, and only after prior investigation by the SEC.⁵⁷ As the SEC is only limited to investigating and prosecuting civil proceedings the Department of Justice is only utilised when the offence committed is serious enough to warrant the initiation of criminal proceedings against the perpetrator(s).⁵⁸ At this stage, all the evidence gained by the SEC is then passed over to the Department of Justice to assist its case. Moreover, evidence obtained by the SEC may be used for ancillary remedies,⁵⁹ such as disgorgement⁶⁰ or restitution in conjunction with any private civil action brought by investors against an insider or manipulator.

As a direct result of the growth of organised insider trading, by the likes of *Ivan Boesky* and *Michael Milken*,⁶¹ and the distortion it had on these markets⁶² during the 1980's new legislation in the form of the *Insider Trading Act 1984* (the 'ITA') and the *Insider Trading and Securities Act 1988* (the 'ITSA') have also been developed and implemented. The ITA empowers the court to impose a civil penalty up to three times

⁵⁷ Ashe, T.M. and Counsell, L. (1993), *infra*, note 104, at 28.

⁵⁸ Hadden, T. (1983) '*Fraud in the City: The Role of the Criminal Law*', Criminal Law Review, at 510 *et seq.* and Janvey, M. (1987), '*Criminal Prosecution of Insider Trading*', Securities Regulation Law Journal, Vol. 15, at 138 *et seq.*

⁵⁹ Farrand, R. (1976), '*Ancillary Remedies in SEC Civil Enforcement Suits*', Harvard Law Review, Vol. 89, at 1802 *et seq.*. Also see *SEC v. Texas Gulf Sulphur Co.* [S.D.N.Y. 1970] 312 F.Supp 77 affirmed [2d Cir. 1971] 446 F.2d 1301, 1307 - 1308 and *SEC v. Golconda Mining Co.* [S.D.N.Y. 1971] 327 F.Supp 257.

⁶⁰ See *Texas Gulf* [1971], *op. cit.*; *Mills v. Electric Auto-Lite Co.* [1970] 396 U.S. 375, 391; *SEC v. Commonwealth Chemicals Sec. Inc.* [2d Cir. 1978] 574 F.2d 90, 120; *SEC v. MacDonald* [1st Cir. *en banc* 1983] 699 F.2d 47, 52-55, *on remand*, [D.R.I. 1983] 568 F. Supp. 111, *aff'd per curiam*, [1st Cir. 1984] 725 F.2d 9; *SEC v. Dennis Levine et al.* 86 Civ. 3726 [RO] [SDNY 1986] and *SEC v. Kidder, Peabody and Co Inc.* 87 Civ. 3869 [RO] [SDNY 1987].

⁶¹ '*Judge Rules on Ivan Boesky Insider Trading Scandal*', *The Independent*, 11/2/97; Comment, '*Insider Trading in Junk Bonds*', (1990) Harvard Law Review, at 1720 and '*Who Dares Wins Wall Street*', *The Independent*, 16/4/95 and Macintyre, A. (1993), '*King of Junk Bonds Pays Campus Dues*', *The Times*, 9/10/93.

⁶² Clarke, M. (1990), *Business Crime: Its Nature and Control*, Cambridge: Polity Press, at 179.

the profit made or loss avoided by insider activities.⁶³ The *ITSA*⁶⁴ extends this liability allowing the *SEC* to increase fines to a maximum of \$1 million for individuals or \$2.5 million for corporations committing insider activities. The *ITSA* also provides a ‘*bounty*’ reward of up to 10% of the penalties to be collected to those who identify or ‘*blow the whistle*’ on insider dealing.⁶⁵

Apart from prosecuting insiders under these two pieces of legislation the *SEC* has also pursued individuals under statutes that were originally not devised to regulate insider dealing. Thus, the use of the Federal mail fraud⁶⁶ and wire fraud⁶⁷ statutes and the *Racketeer Influenced and Corrupt Organisations Act 1970* (the ‘*RICO*’) have been successfully used on numerous occasions by the *SEC* to prosecute insider dealing. The *RICO* allows the *SEC* to implement triple damages⁶⁸ and/ or the use of imprisonment as well as allowing them to bring civil actions against syndicates of organised rings of insiders.

The adoption of what some have referred to as a ‘*super SIB*’ has prompted many to speculate that a regime not unlike that of that used in the United States will be implemented in this country.⁶⁹ Although it is highly probable that changes will be

63 The *ITA* is specifically aimed at the trading of persons with advanced knowledge of take-over attempts of market information, such as in the *Chiarella* [1980]; see ‘*A Critique of the Insider Trading Sanctions Act of 1984*’, (1985) 71 *Virginia Law Review*, at 470 *et seq.*

64 Friedman, D. (1990), *The Insider Trading and Securities Fraud Enforcement Act of 1988*, *North Carolina Law Review*, Vol. 68, at 465 *et seq.*

65 Section 21A(e). Also see Loss, L. and Seligman, J. (1993), *Securities Regulation* (3rd edition), Boston: Little, Brown and Company, at 3758-3761.

66 18 U.S.C. § 1341.

67 18 U.S.C. § 1343. Also see Janvey, M. (1987), *supra*, note 58, at 140 *et seq.*

68 18 U.S.C. §§ 1954(c) and 1964(c).

69 Commentary, ‘*Regulators Back in the Melting Pot*’, *The Times*, 21/5/97. Certain academics have long been of the opinion that a ‘*super-SIB*’ should have been implemented in the United Kingdom before the advent of the Financial Services Authority; Posner, R.A. (1991), *International Securities Regulation*, at 112 *et seq.* and Fishman, J.L. (1993), *The Transformation of Threadneedle Street: The Deregulation and Reregulation of Britain’s Financial services*, London: Macmillan, at 298 *et seq.*

made, total reliance on the American system is unlikely or even desirable.⁷⁰

Therefore, while structural changes in the United Kingdom are likely to be influenced by the American experience fundamental changes regarding funding, attitude and bureaucratic matters are likely to remain quiescent.

Many of those interviewed for this research mirrored these opinions although some were more forthcoming than others in what they believed would be likely to change and what they would like to see changed.⁷¹ Interestingly, of those involved with the extensive penalisation of insider dealing and market manipulation commended some of the novel approaches adopted by the United States. In particular, the use of plea-bargaining and the effective use of disgorgement remedies mentioned as beneficial attributes that should where possible be implemented in this country. However, the idea of adopting procedural and substantive changes exclusively modelled on the United States were substantially frowned upon as being totally out of place and unworkable in the present United Kingdom market environment. Indeed, ideas such as combining the role of the civil and criminal law against market abusers⁷² and bounty payments to informers were scathingly criticised, a view echoed by other academics.⁷³

⁷⁰ Rider, B.A.K. (1988), '*Policing the City-Combating Fraud and Other Abuses in the Corporate Securities Industry*', Current Legal Problems, at 51.

⁷¹ A full account of the each interview undertaken and the methods used to facilitate the flow of information gain can be found in appendix one.

⁷² *Op cit.* The implementation of this idea was not favoured by the majority of respondents interviewed how saw the use of both forms of law in '*double jeopardy*' manner to be less than productive and a waste of time and resources. Indeed, some showed concerned that certain civil liberties may be infringe if such a system was adopted. *See also* chapter five.

⁷³ Rider, B.A.K. and Ashe, T.M. (1993), *Insider Crime – The New Law*, London: Jordans, at 1.

2.2. The Notion of Disclosure

In their barest form, any financial market can be perceived as a market of information that is continually influenced by the trading and predictions made by market forces. Investments in these markets are what economists term public or experience goods, as their quality cannot be assessed in advance.⁷⁴ This is due to such forces altering the supply or demand quotation allocated towards a particular security through the application of information that relates to that security. Insider dealing and market manipulation also relies on this assumption although both derive a distinct trading advantage on either undisclosed information or interfering with the market information available.⁷⁵ Consequently, the principle of disclosure is used to make sure that traders and investors alike have the same information and hence the same chance of making the same decisions.⁷⁶

The principle of disclosure forms a cornerstone of English and American securities regulation.⁷⁷ Generally, disclosure is used as a device to advance three main objectives.⁷⁸ Firstly, it can be used to aid law enforcement.⁷⁹ Secondly, it is

74 Nelson, D. (1970), '*Information and Consumer Behaviour*', *Journal of Political Economy*, Vol. 78, at 311 and Gower, L.C.B. (1982), *Review of Investor Protection: A Discussion Document*, Cmnd. 7937, London: Macmillan, at paragraph 2.01.

75 Boyle, T. (1992), '*A Theory of Law and Information: Copyright, Spleens, Blackmail, and Insider Trading*', *California Law Review*, Vol. 80, at 1429 *et seq.*

76 Baiman, E., Stanley, N. and Verrecchia, R. (1996), '*The Relation among Capital Markets, Financial Disclosure, Production Efficiency, and Insider Trading*', *Journal of Accounting Research*, Vol. 34, at 4 *et seq.*

77 In particular, the United States has a vast amount of legal literature on this area, see, for example, Gordon, G. and Kornhauser, I. (1985), '*Efficient Markets, Costly Information and Securities Research*', *New York University Law Review*, Vol. 60, at 761 *et seq.*

78 '*Disclosure as a Legislative Device*', (1962-63) *Harvard Law Review*, Vol. 76, at 1273.

79 This is especially true in the United States where the disclosure principle was used to great effect in forging the SA and SEA.

"... To the proponents of the 1933 and 1934 securities laws, prevention of excessive insider or underwriter compensation was nearly as important a justification for these acts as the prevention of fraud. Insider conflicts of interest, self-dealing, waste or unfair transactions, it was argued, were less likely to occur if the insider realised that the material details of such transactions would have to be disclosed..."

used to discourage particular forms of conduct by invoking public disapproval of such conduct.⁸⁰ Thirdly, it may be used simply for its informative effect.⁸¹ Thus, while some of the provisions of securities laws are designed to have an enforcement effect, most of the provisions are geared towards informing intended recipients.⁸²

In the United States, the SEC has been empowered under the *SA* with the duty to police the use of disclosure obligations relating to public companies that wish to sell their securities. Under the *SA* these types of companies must comply with the SEC's disclosure regulations regarding registration of classes of securities, the filing of periodic reports, the solicitation of proxies and the contents of tender offer documents.⁸³ Through these securities rules and laws the SEC determines what disclosures publicly held corporations must make in the registration and disclosure

; Seligman, J. (1983), '*The Historical Need for a Mandatory Corporate Disclosure System*', *Journal of Corporate Law*, Vol. 9, at 45 *et seq.*

80 Anderson, A. (1974), '*The Disclosure Process in Federal Security Regulation*', *Hastings Law Review*, Vol. 25, at 311; Brundney, V. (1979), '*Insiders, Outsiders and Information Advantages under the Federal Security Regulation: A Brief Review*', *Harvard Law Review*, at 322 and Knauss, T. (1964), '*A Reappraisal of the Role of Disclosure*', *Michigan Law Review*, Vol. 62, at 615 *et seq.*

81 "... *If market forces are to operate properly it is essential that ... as much information as possible is disclosed about the investments and services on offer to the customer...*"

; *FSA White Paper*, at paragraph 3.2(1) and *Company Law Reform*, (1973), Cmnd. 5391, at paragraph 15.

82 The term '*sunlight effect*' is used to describe the philosophy of disclosure. The originator of this phrase was Brandeis, B. (1963), *Other People's Money*, (1963), at 62:

"... *Sunlight is said to be the best of disinfectants; electric light the most efficient policeman...*"

Also see *Hansard*, LXXV [1844], at 277, where Gladstone made similar observations regarding disclosure obligations:

"*Publicity is all that is necessary. Show up the roguery and it is harmless.*"

Also see Werner, B. (1984), '*The SEC as a Market Regulator*', *Virginia Law Review*, Vol. 70, at 755.

83 Such compliance also applies to corporations that publicly traded shares that have assets of \$5 million or more and have a class of equity securities held by 500 or more persons. U.S. stock exchanges have disclosure requirements in their listing rules, but the SEC has plenary authority to alter these rules so that they conform with U.S. securities legislation; Lipton, S. (1983), '*The SEC or the Exchanges: Who Should Do What and When? A Proposal to Allocate Regulatory*

process.⁸⁴ Additionally, officers, directors and 10% shareholders of public companies are all subject to reporting requirements.⁸⁵

By comparison, the United Kingdom position regarding disclosure principles is primarily dealt with by the Stock Exchange under obligations derived from the *FSA*.⁸⁶ Thus, where a company seeks to raise capital by a direct offer of securities to the public, over and above the obligation to comply in detail with the listing particulars, the *FSA* imposes a general duty referring to what must be contained in such a listing,⁸⁷ a duty for which the Stock Exchange is responsible. The requirements for listing that must be complied with are set out in the Listing Rules, commonly referred to as the '*Yellow Book*'.⁸⁸ The Stock Exchange, through the Listing Rules, requires that an issuer of listed securities must make full and timely disclosure about itself and

Responsibilities for Securities Markets, University of California at Davis Law Review, Vol. 15, at 529 *et seq.*

- 84 Until 1976 the SEC took the view that projected values were not material although after this time it did change its policy to permit rather than mandate the use of such projections or forecasts; Fiftis, T. (1978), '*Soft Information: The SEC's Former Exogenous Zone*', University College Los Angeles Law Review, Vol. 26, at 103 *et seq.* and *Policy Statement on Disclosure of Projections of Future Economic Performance*, Securities Act Release No. 5362, Exchange Act Release No. 9984, [1972-1973 transfer binder] ed. Sec. L. Rep. (CCH 79,211, at 82) (2/2/73).
- 85 The Financial Accounting Standards Board (FASB) is one body of a self-regulatory nature that plays an important part in the United States. Securities legislation empowers the SEC to establish accounting standards with which publicly traded corporations must comply when they disclose financial data. The SEC relies in large measures on the FASB to formulate the relevant rules. The Board's leading members are accountants and thus, in effect, accountants play a key part in setting accounting standards; Stevenson, H. (1980), *Corporations and Information: Secrecy, Access and Disclosure*, New York: Little, Brown and Co, at 94 *et seq.* *cf.* Longstreth, I. (1984), '*The SEC's Role in Financial Disclosure*', Journal of Accounting, Auditing and Finance, Vol. 7, at 116 *et seq.*
- 86 *Infra.* Although other disclosure requirements are required under sections 251 and 329 and Schedule 7 (Miscellaneous), paragraph 6 of the *Companies Act 1985*. However, such disclosure obligations have not gone uncriticised:
- "... There is far more myth than truth in the law's perennial assumption that those who deal with limited companies get any real protection or help from information which a search of the registers will yield for them..."
- , Sealy, L. (1984), *Company Law and Commercial Reality*, London: Butterworths, at 25 *et seq.*
- 87 Sections 146 - 147 *FSA '86*.
- 88 Gee, C. (1994), '*Transparency and the New Yellow Book*', International Company and Commercial Law Review, Vol. 1, at 11.

its listed companies, at the time of listing and subsequently.⁸⁹ Initial disclosure is therefore required, which must be comprehensive and, secondly, continuing obligations will apply following admission to listing. These obligations are specifically relevant to listed securities and are therefore designed to erode informational advantages at the earliest possible time, theoretically reducing the chances of fraudulent activity involving such securities⁹⁰, although this has not been conclusively proven.⁹¹ Thus, it can be noted that both the United Kingdom and United States rely on disclosure principles enacted under statute to make sure that an even playing field is provided.⁹² Yet, can this be justified given that there are those who believe that market forces themselves can and should adequately determine what optimum level information ought to be disclosed at?

Many of those who argue against mandatory disclosure believe that the market provides enough incentives for the production of relevant information.⁹³ This is based on the belief that investors desire information because it provides them with the only medium by which they can increase the monetary value of their investments and therefore creates a demand for such information. Firms also benefit from such disclosure as the more information a company provides the more likely investors will

89 See *Yellow Book*, at chapters one, five, six and nine.

90 Benston, E. (1973), '*Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act 1934*', *American Economic Review*, Vol. 63, at 132.

91 Sommer, G. (1974), *The Other Side Financial Executive*, London: Macmillan, at 36.

92 Although Rider, B.A.K. (1983), advocates that insider dealing can be regulated not only through disclosure but also self-regulation, criminal and civil forms of sanctioning; *Insider Trading*, London: Jordans, at 7 *et seq.*.

93 Gonedes, C. (1976), '*Disclosure Rules, Information - Production and Capital Market Equilibrium: The Case of Forecast Disclosure Rules*', *Journal of Accounting Research*, Vol. 14, at 89; Mirman, J. and Samuelson, D. (1989), '*Information and Equilibrium with Inside Traders*', *Economics Journal*, Vol. 99, at 152 *et seq.*; Benston, E. (1969), '*The Value of the SEC's Accounting Disclosure Requirements*', *Accounting Review*, Vol. 44, at 515; Guo, J. (1995), '*'Analysts' Forecasts: Low-Balling, Market Efficiency, and Insider Trading*', *Financial Review*, Vol. 30, 531 *et seq.*; Karmel, A. (1993), '*The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why A Property Rights Theory of Inside Information is Untenable*', *Brooklyn Law Review*, Vol. 59, at 152 *et seq.*; Hirschleiffer, D. (1971), '*The Private and Social Value of Information and the Reward to Inventive Activity*', *American Economics Review*, Vol. 61, at 563 *et seq.* and Fox, T. (1994), '*Insider Trading Deterrence Versus Managerial Incentives: A Unified Theory of Section 16(b)*', *Michigan Law Review*, Vol. 92, at 2089 *et seq.*.

trade upon them. Therefore, companies and investors alike can derive benefit⁹⁴ from this situation by mutual agreement.⁹⁵

However, if voluntary disclosure is to work investors must have initial confidence in the firms they invest in. Therefore, in order to allay any suspicions a firm must be able to show any potential investor that it is *bone fide*. This may be achieved through the use of external parties such as accountants to audit corporate accounts to verify the accuracy of the information provided by the company and present it in a clear and precise form.⁹⁶ Management could further enhance its credibility by taking substantial positions in the companies stock by way of stock options or otherwise.⁹⁷ This would give the management an incentive to enhance the value of the companies stock, thereby aligning its interest with those of the investors. However, given that predictions generated by accountants tend to be conservative estimates based on past performance and asset levels any financial information relating to securities in that company, which wishes to attract investors, may well give a false indication as to that companies future performance.⁹⁸ Such conservatism on the part of accountants in estimating a company's profit or loss is often attributed to the fear of legal action if their reports prove widely inaccurate.⁹⁹

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- 94 Samuelson, D. (1964), '*The Pure Theory of Public Expenditures*', 36 *Review of Economics and Statistics*, Vol. 26, in Minasian, H. (1964), '*T.V. Pricing and the Theory of Public Good*', *Journal of Law and Economics*, Vol. 7, at 71.
- 95 Benston, E. (1979), '*Required Periodic Disclosure Under the Securities Acts and the Proposed Federal Securities Code*', *University of Miami Law Review*, Vol. 33, at 1471.
- 96 Jagannathan, J. and Palfrey, H. (1989), '*Effects of Insider Trading Disclosures on Speculative Activity and Future Prices*', *Economic Inquiry*, Vol. 27, at 413 *et seq.* and Kripe, D. (1970), '*The SEC, the Accountants, some Myths and some Realities*', *New York Law Journal*, Vol. 45, at 1164 *et seq.*
- 97 Easterbrook, A. and Fischel, H. (1980), '*Mandatory Disclosure and the Protection of Investors*', *Virginia Law Review*, Vol. 70, at 679.
- 98 Sullivan, P. (1990), '*Materiality of Predictive Information after Basic: A Proposed Two-Part Test of Materiality*', *Illinois Law Review*, at 227 and '*Mandatory Disclosure of Corporate Projections and the Goals of Securities Regulations*', (1981) *Columbia Law Review*, Vol. 81, at 1542 *et seq.*
- 99 See generally Ferris, M. (1973), '*Profit Forecast Disclosure – The Effect of Managerial Behaviour*', *Accounting and Business Research*, at 136; Penman, C. (1982), '*Insider Trading and the Dissemination of Firms' Forecast Information*', *Journal of Business*, Vol. 55, at 479 *et seq.* and Penman, C. (1985), '*A Comparison of the Information Content of Insider Trading and*

Under a system of voluntary disclosure any individual may benefit from the use of such information, even if he has not paid for acquiring it. Therefore, the original producer of the information will not be able to capture all the benefits that may be derived by disclosure.¹⁰⁰ This may result in information not being forthcoming due to the absence of incentive. In addition, if the company producing the information has a dominant market position it will be less than forthcoming in the production of information if this will undermine its position unless it is legally required to do so.

Sole reliance on the market to provide the optimum disclosure of information is also inappropriate, based as it is on the presumption that the market does not afford equal access to all users or potential users of the information. Therefore, in the absence of a rule compelling the disclosure of information, companies or individuals might make selective disclosures to favoured or more important customers. Another problem associated with voluntary disclosure relates to the notion that the information disclosed might be selective in nature. Thus, it may be in management's self interest to disclose only favourable information and suppress unfavourable information because of the adverse impact it might have on the market value of its shares. It can be generally observed that it is common to find firms with nothing important to disclose comply quickly with requirements of disclosure.

Another criticism of voluntary disclosure relates to the premise that companies know what is good for their shareholders.¹⁰¹ This view assumes that the interests of shareholders and management coincide. Managers who wish to profit from trading on inside information will have an incentive to withhold important information. A similar incentive would also exist if the management has an interest in buying out its shareholders.¹⁰² An additional consideration is the notion that a firm will be

Management Earnings Forecasts', Journal of Financial and Quantitative Analysis, Vol. 20, at 3 *et seq.*

¹⁰⁰ Bearles, T. (1981), '*The Efficient Regulation of Consumer Information*', Journal of Law and Economics, Vol. 24, at 512 *et seq.*

¹⁰¹ Benston, E. (1979) himself recognised these limitations; *supra*, note 95, at 1476-7.

¹⁰² According to Coffee, H. (1984), '*Market Failure and the Economic Case for a Mandatory Disclosure System*', Virginia Law Review, Vol. 70, at 741, the absence of a mandatory disclosure system is likely to increase the popularity of leveraged buyouts by the management.

compelled to disclose bad news because it may induce the belief in investors that the management has something even worse to hide is not entirely plausible. An investor cannot judge whether a piece of news is good or bad without first knowing what the news is. While a company may not be in a position to disclose good news all the time, it does not always have to disclose bad news whenever there is any. It could be selective about the revelation of bad news. Management may even falsely perpetuate, for its own advantage, the belief that something worse is being hidden. It may withhold information with a view to acquiring securities at a lower price. The information ultimately disclosed might in fact be good news for the investors but the management would have achieved its objective of purchasing the shares at a bargain price.

A system of voluntary disclosure may also lead to inefficiency in the market for information.¹⁰³ The inefficiency may take the form of wasteful or excessive expenditure in gathering information, because investors are likely to duplicate their efforts in gathering the same information. Mandatory disclosure substantially reduces this wasteful expenditure of investor resources by creating a centralised depository for information.

The incentive for non-disclosure arises because the withholding of information may prevent an appreciation of the share price. To achieve its result, the management might also be induced to provide false information that will have the effect of depressing the share prices.

¹⁰³ Mahoney, E. (1992), '*Precaution Costs and the Law of Fraud on Interpersonal Markets*', *Virginia Law Review*, Vol. 78, at 631 *et seq.*

2.3. Regulation, Insider Dealing and Market Manipulation

Historically, insider practices have incited controversy due to the lack of universal acceptance as to the harmful effect they may have upon financial markets.¹⁰⁴

Accordingly, two opposing schools of thought, those that seek to oppose or propose the need for regulating these practices, have developed. Alternatively, these academic opinions can be further sub-categorised in relation to their legalistic,¹⁰⁵ economic¹⁰⁶ or jurisprudential standing. The view adopted both in the United Kingdom and the United States, as with most other developed financial markets, is that these practices should be regulated. Accordingly appropriate legislative measures have been enacted. Yet, can such views and actions be wholly justified given that opposing arguments exist?

Over the years many arguments have been advanced relating to the belief that insider dealing should not be regulated.¹⁰⁷ The main thrust of such a general consensus centres on the notion that insider dealing and manipulative practices can generate more benefits than harm.¹⁰⁸

¹⁰⁴ Contrast the historical observation made by Ashe, T.M. and Counsell, L. (1993), *Insider Trading*, (1993), London: Fourmat Publishing, at 5:

“...in the late 1800s and well into this century such insider trading in shares was perceived by many as a perk of the job in a system often regarded as fair game and always in season...”

, with the observation made in programme *Naked City*, BBC 2, November 1996 and Cox, E. (1986), ‘*Insider Trading Regulation and the Production of Information: Theory and Evidence*’, Washington University Law Quarterly, Vol. 64, at 476 *et seq.*

¹⁰⁵ *Post.*

¹⁰⁶ See generally Haddock, J. and Macey, K. (1987), ‘*Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*’, Journal of Law and Economics.

¹⁰⁷ *Post.*

¹⁰⁸ See generally Manne, H. (1966(a)), *Insider Trading and the Stock Market*, (1966(a)), Boston: Little, Brown and Co; Manne, H. (1966(b)) ‘*In Defence of Insider Trading*’, Harvard Business Review, Vol. 44, No. 6, at 113; Manne, H. (1967), ‘*What’s so bad about Insider Trading*’, Challenge, Vol. 15, at 14; Manne, H. (1970), ‘*Insider Trading and the Law Professors*’, Vanderbilt Law Review, Vol. 23, at 547; Kay, M. (1973), ‘*The Justice Report on Insider Trading*’, Modern Law Review, Vol. 36, at 185; Manne, H. (1974), ‘*Economic Aspects of Required Disclosure Under Federal Securities Laws*’ in *Wall Street in Transition: The Emerging System and its Impact on the Economy*, Boston: Little Brown and Co; Dooley, C.

Opponents to the regulation of insider dealing believe that this practice benefits financial markets by enhancing the value of securities through the elimination of market distortion, thereby enhancing fluidity in market prices.¹⁰⁹ Consequently, dealings by an insider connected with a listed company may be perceived as a barometer as to that company's financial health. Thus, any dealings in that company by such an insider may invariably aid securities prices to reach higher levels which ordinarily would not materialise if such inside information were to have been made more freely available.¹¹⁰ Outsiders, therefore, through this argument, are seen to benefit from the disclosure of everything known about the company, public or not, via insider dealing¹¹¹ since such dealings indirectly reduce speculation.¹¹² Contextually, any laws that seek to prohibit insider dealing would severely curtail any legitimate information gathering activities taken by those individuals, such as market analysts, in providing an informed and efficient securities market. Indeed, the existence of informational variances serves as an incentive for market analysts to discover new information.¹¹³

(1980), '*Enforcement of Insider Trading Restrictions*', Virginia Law Review, Vol. 66, at 1; Carlton, K. and Fischel, H. (1983), '*The Regulation of Insider Trading*', Stanford Law Review, Vol. 35, at 857; Seligman, J. (1983), '*An Economic Defence of Insider Trading*', Fortune, Vol. 108, at 47 and Cottrell, E. (1986), '*Insider Dealing in the United States*', New Law Journal, Vol. 14, at 150.

¹⁰⁹ Manne (1966(a)), *op. cit.*, at 77 *et seq.*

¹¹⁰ JUSTICE Report on Insider Trading, (1972), at paragraph 2.

¹¹¹ Manne, H. (1966(b)), *supra*, note 108, at 115; Manne, H. (1970), *supra*, note 108, at 570, Cottrell, E. (1986), *supra*, note 108, at 150 *et seq.*; Carlton, K. and Fishel, H. (1983), *supra*, note 108, at 867 *et seq.* and Strickler, J. (1985), '*Inside Information and Outside Traders: Corporate Recovery of the Outsider's Unfair Gain*', California Law Review, Vol. 73, at 487 *et seq.*

¹¹² Baesel, J. and Stein, P. (1979), '*The Value of Information: Inferences from the Profitability of Insider Trading*', Journal of Financial and Quantitative Analysis, Vol. 4, at 556 *et seq.* and Demsetz, J. (1986), '*Corporate Control, Insider Trading and Rates of Return*', American Economic Review, Papers and Proceedings, Vol. 76, at 314 *et seq.*

¹¹³ Wihlborg, F. (1990), '*The Incentive to Acquire Information and Financial Market Efficiency*', Journal of Economic Behaviour and Organization, Vol. 13, at 349 *et seq.*; Corgill, K. (1996), '*Insider Trading, Price Signals, and Noisy Information*', Indiana Law Review, Vol. 71, at 356 *et seq.*; Damodaran, P. and Liu, D. (1993), '*Insider Trading as a Signal of Private Information*', Review of Financial Studies, Vol. 6, at 80 *et seq.*; Finnerty, I. (1976), '*Insiders and Market Efficiency*', Journal of Finance, Vol. 31, at 1145 *et seq.*; Kerr, T. (1980), '*The Battle of Insider Trading vs. Market Efficiency*', (1980) 6 Journal of Portfolio Management, at 48 *et seq.*; Goldie, H. and Ambachtsheer, T. (1981), '*The Battle of Insider Trading vs. Market Efficiency: Comment*', Journal of Portfolio Management, Vol. 7, at 88 *et seq.*; Fishman, J.L. and Hagerty, A. (1992), '*Insider Trading and the Efficiency of Stock Prices*', Rand Journal of Economics, at

However, there are shortcomings in the validity of this argument for even if insiders trade secretly they cannot effectively eliminate all market distortion.¹¹⁴ Therefore, the insider is the only one who ultimately profits from such activities. Disclosure of inside information by insiders at an extremely early stage seems the only way of preventing such individuals making any profit and at the same time allowing the market to benefit.¹¹⁵ Yet, in order to do this the market must initially know who the insiders are.¹¹⁶ Insiders, though, are rarely honest enough to admit their identity and usually can find ways of concealing it.¹¹⁷ Therefore, the market must not only be able to identify the insider but also react accordingly in order for the securities price to be truly represented. However, not all insider dealing activities will reflect the insiders' true intentions. Accordingly, as dealing possesses incentives for insiders to manipulate the substance as well as the timing of corporate information to their own advantage they may induce the market to follow a bogus lead by purchasing securities initially and then selling them in the resulting rising market.¹¹⁸ Additionally, where insiders operate in networks designed to exchange confidential

108 *et seq.* and Friedman, D. (1982), '*Efficient Market Theory and Rule 10b-5 Non Disclosure Claims: A Proposal for Reconciliation*', Missouri Law Review, Vol. 47, at 746 *et seq.*

- 114 Gilson, I and Kraakman, G. (1984), '*The Mechanisms of Market Efficiency*', Virginia Law Review, Vol. 70, at 549 and Fisch, H. (1991), '*Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*', Georgia Law Review, Vol. 26, at 180 *et seq.*
- 115 Samuelson, D. (1988), '*The Prevention of Insider Trading: A Proposal for Revising Section 16 of the Securities Exchange Act of 1934*', Harvard Journal on Legislation, Vol. 25, at 511; Campbell, (1996), '*Why Insider Dealing Is Wrong*', Legal Studies, Vol. 16, at 185 *et seq.*; Levmore, R. (1988), '*In Defense of the Regulation of Insider Trading*', Harvard Journal of Law and Public Policy, Vol. 11, at 102 *et seq.* and Leland, J. (1992), '*Insider Trading: Should it be Prohibited?*', Journal of Political Economy, Vol. 100, at 860 *et seq.*
- 116 Langevoort, S. (1990), '*Investment Analysts and the Law of Insider Trading*', Virginia Law Review, Vol. 76, at 1038.
- 117 *The Times*, 8/1/90 reported allegations that a network existed in London for exchanging inside information.
- 118 Mendelson, K. (1969), '*The Economics of Insider Trading Reconsidered*', University of Pennsylvania Law Review, Vol. 117, at 473 *et seq.* and Eyssell, J. (1991) '*Corporate Insiders and the Death of the Firm: Evidence on the Incidence of Insider Trading in Corporate Dissolutions*', Financial Review, Vol. 26, at 518 *et seq.*

information for mutual benefit, the supposed advantages caused by insider dealing are negligible.¹¹⁹

While it must be acknowledged that some of the arguments put forward by those that seek not to regulate these activities are convincing, the credibility of such beliefs rests on the premise that fundamental questions can firstly be convincingly answered. This, it seems, has not been accomplished. Thus, it may be perceived, that this school of thought fails not only to adequately explain why an insider, rather than the company with which he may be associated, usually profits from the price sensitive information he uses, but also fails to provide a credible explanation for the situation where an insider may effect the market by way of having in his possession information which, when used, will have a derogatory effect on the market. It has been suggested that in this regard an insider would trade at the market price of the securities or at a price nearest to it rather than offering to sell at a price that reflects the value of the undisclosed information.¹²⁰ If this is the case, insider dealing will send false signals to the market rather than bring the price of securities to their current levels. Yet, the culmination of all these arguments may be of little significance given the effects technological advancements have had on spontaneity of market transactions. Hence,

“... it is argued that in the modern market insider dealing will hardly affect the price of an actively traded stock at all.”¹²¹

Conventionally, a company can usually make a profit from any price sensitive information generated by either dealing in its own shares or by selling such

¹¹⁹ Garten, S. (1987), *‘Insider Trading in the Corporate Interest’*, Wisconsin Law Review, at 574 *et seq.* and Fried, W. (1997), *‘Towards Reducing the Profitability of Corporate Insider Trading’*, Southern California Law Review, Vol. 70, at 376 *et seq.*

¹²⁰ Anisman, P. (1986), *Insider Trading Legislation for Australia: An Outline of Issues and Alternatives*, Canberra: Australian Government Publications, at 8 *et seq.*

¹²¹ Ashe, T.M. and Counsell, L. (1993), *supra*, note 104, at 25.

information to outsiders.¹²² Yet, as is often the case, the company may have legitimate business reasons for keeping information confidential so that dealing by insiders may not only be prejudicial, at that moment, to the company's interests but also hinder the disclosure of information by that company in the future.

The practice of market manipulation can be extremely difficult to define in terms of legitimacy. While it is widely acknowledged that well-known practices such as '*matched orders*' and '*wash trading*' amount to manipulation, confusion is often encountered when new forms of alleged manipulation are detected. Thus, if an individual trades on the belief or premonition that his trading activities will cause a marked rise in the security he is trading upon and actually does, will this amount to a manipulative practice? The answer is 'yes' as his activities have had the same end result as those classed as definite manipulative practices, even though in the latter example the individual involved did not have a dishonest intent. Therefore, given this ambiguity it is surely too broad to regulate market manipulation given the problems that may be encountered in defining such behaviour.

Yet, if this line of thought is applied to insider dealing, especially to the laws that govern this area in the United Kingdom, the opposite assumption can be made. *Reichman*, for instance, argues that given insider activities tends to evolve with technological advancement it has become more difficult to identify clearly. Therefore the resulting imprecision may stifle the effective enforcement of such rules. Thus, a more fluid approach needs to be adopted by the United Kingdom if it is to overcome this.¹²³

It is generally accepted by this school of thought that since insider dealing usually takes place through the medium of impersonal exchanges, it is impossible to

¹²² Cox, E. (1986), '*Insider Trading and Contracting: A Critical Response to the Chicago School*', *Duke Law Journal*, at 629 and Levmore, T. (1982), '*Securities and Secrets: Insider Trading and the Law of Contracts*', 68 *Virginia Law Review*, Vol. 68, 121 *et seq.*

¹²³ Reichman, N. (1993), '*Insider Trading*' in Tonry, M. and Reiss, A.J. Jr (eds.) (1993), *Beyond the Law, Crime in Complex Organisations*, Chicago: University of Chicago Press, at 60.

identify the victims involved,¹²⁴ let alone the insider.¹²⁵ Outsiders who enter the market do so voluntarily, without inducement by insiders and regardless as to their activities. Therefore, if distortions in the market already existed, it is argued that they would have been caused by the non-disclosure by the company in the first place regardless as to the fact that an insider may be in possession of confidential information.¹²⁶ Following on from this argument, an outsider's loss is, in essence,

¹²⁴ Douglas, L. (1988), *'Insider Trading: The Case Against the 'Victimless Crime''*, Financial Review, Vol. 23, at 128 *et seq.*; Manne, H. (1966(a)), *supra*, note 108, at 110 *et seq.*; Manne, H. (1985) suggests:

"... the most fundamental economic proposition in the whole topic of insider trading is that no shareholder is harmed..."

, *supra*, note 108, at 933. In addition, Manne, H. (1985) goes on to make the assumption that:

"... the modern academic literature now recognises that there is no significant economic harm to any identifiable group of investors from insider trading..."

; *op. cit.*, at 934. This view is also supported by other academics. Prentice, D. (1975), makes note that:

"... while a shareholder who deals with an inside may have a justifiable sense of grievance if at the time the insider is in possession of confidential information there is no way in which this sense of grievance can be translated into a casual connection showing loss attributable to the insider's trading..."

, *'Insider Trading'*, Current Legal Problems, at 91. Additionally, see Easterbrook, A. (1981), *'Insider Trading, Secret Agents, Evidentiary Privileges and the Production of Information'*, Supreme Court Review, at 324 *et seq.*; Hetherington, M. (1967), *'Insider Trading and the Logic of Law'* Wisconsin Law Review, at 723 *et seq.* and Herman, R. (1973), *'Equity Funding, Inside Information and the Regulators'*, University College Los Angeles Law Review, Vol. 21, at 17. Contrast these views with Carney, J. (1986), *'Signalling and Causation in Insider Dealing'*, Catholic University Law Review, Vol. 36, at 863 *et seq.*

¹²⁵ In *Chase Manhattan Equities Ltd v. Goodman* [1991] BCLC, at 933 Knox J. noted:

"... What is sufficient... is that it is not a crime without a villain..."

¹²⁶ For a view on how outsiders may benefit from insider dealing see Herzel, J. and Katz, F. (1987), *'Insider Trading: Who Loses'*, Lloyds Bank Review, Vol. 165, at 15 and *Justice Report on Insider Trading*, (1972), at paragraph 2:

"... When a director buys on the market in the knowledge of a forthcoming bid for the company, the seller of the shares would probably have put up his shares for sale anyway and the price he gets may in fact have been slightly raised by the fact that the director is in the market as a buyer..."

Also, see generally Haft, G. (1982), *'The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation'*, Michigan Law Review, Vol. 80, at 1051 and Klock, T. (1994), *'Mainstream Economics and the Case of Prohibiting Inside Trading'*, Georgia State University Law Review, Vol. 10, at 304:

caused by his own ignorance in not knowing the market as well as he should have.¹²⁷ However even if this is so losses will always have a tendency to remain ‘invisible’, as the fear of unwanted publicity by investors¹²⁸ or loss of face by companies who are aware of the trading activities of an insider are reluctant to raise the issue with the relevant authorities.¹²⁹ Therefore, although it seems apparent that no one definite victim can be identified, if insider dealing and market manipulations are allowed to infest, investors, market-makers¹³⁰ and the market itself¹³¹ will become their unwilling victims.

“... if the market price is currently fifty dollars and insiders know that the true value is fifty-five dollars and trade on information, the price will rise. Non-insiders who sell during this period will receive less than the true value, but they sold voluntarily and would have only received fifty, if not for insider trading. Thus, insider trading actually benefits the non-insider.”

127 Painter, T. (1965), ‘*Insider Information, Growing Pains for the Development of a Federal Corporation Law Under Rule 10b-5*’, Columbia Law Review, Vol. 65, at 1386. However, there are those who believe that insider dealing does harm market participants; Wang, J. (1981), ‘*Trading on Material Non-Public Information on Impersonal Markets: Who is Harmed, and Who can Sue Whom Under SEC Rule 10b-5?*’, Southern California Law Review, Vol. 54, at 1234 *et seq.*

128 Rider, B.A.K. (1991), ‘*Policing Insider Dealing in Britain*’, in Hopt, K. and Wymeersch, E. (eds.) (1991), *European Insider Dealing*, London: Butterworths, at 321.

129 See generally Langevoort, P. (1982), ‘*Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*’, California Law Review, Vol. 70, at 1 *et seq.*

130 King, T. and Roell, H. (1988), ‘*Insider Trading*’, Economic Policy, at 168 *et seq.*

“In practice the direct victim of insider trading is most likely to be the market maker with whom [the insider] trades”

131 *Diamond v. Oreamuno* [1968] 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910, at 912:

“When officers and directors abuse their position in order to gain personal profits, the affect may be to cast a cloud on the corporation’s name, injure stockholder relations and undermine public regard for the corporation’s securities.”

and Goodhart, J. (1987), ‘*The Economics of ‘Big Bang’*’, Midland Bank Review, at 10:

“... Sometimes [insider dealing]... is referred to as a ‘victimless crime’. That is actually incorrect. The operations of insider traders effectively cause losses to market-makers with which they deal. In order to recoup such losses, market makers have to widen their spreads that they charge all other investors, including those wishing to speculate but not privy to inside information. The ultimate victims, therefore, are the ordinary investors who have to pay indirectly higher transactions charges for the gains of the insiders. So there are real benefits to obtained in preventing it...”

and House of Commons Official Report, 20/12/94, at column 1593.

Yet proponents of insider dealing advocate that it forms a necessary part for compensating individuals who through their '*skills*' at becoming an insider should therefore receive a reward for their entrepreneurial exploits.¹³² The crux of this argument focuses on the notion that managers and executives will settle for a lower level of compensation in the forms of salaries, bonuses and other explicit rewards if they are also allowed to use their position to benefit from dealing and profiting from the use of inside information. If this is allowed, it is argued, shareholders will directly benefit from the lower salaries and bonuses companies usually pay such individuals, and consequently there will be a reduced chance that salaries will therefore need renegotiating.¹³³ Additionally, the prospect of making profits from inside information will act as an incentive for those who possess such entrepreneurial skills to seek positions in companies and as a result will act as a natural '*sifting*' process sorting out those managers who have superior skills from those that inferior ones in the company.

This line of argument, although elaborate, has a number of weaknesses. Firstly, it assumes that all insiders are blessed with entrepreneurial skills.¹³⁴ Yet, this assumption can be seen as wrong since such activities can be carried out by those people deemed tippees, such as secretaries or printers, who through the very nature of their position come across such price sensitive information and act upon it. Secondly, the entrepreneurial argument also ignores the reality that the managers themselves determine compensation schemes offered to managers as they are the ones in a position of controlling such companies. It therefore seems that the idea of rewards for entrepreneurs enables insiders to share in the gains of the enterprise irrespective of whether they contributed to its gains or not. Thus, the benefit and the amount of the gains are unpredictable. In addition, there is no assurance that an insider alone will

¹³² Manne, H. (1966(a)), *supra*, note 108, at 131 et seq. and Manne, H. (1966(b)), *supra*, note 108, at 111 et seq..

¹³³ Manne, H. (1970), *supra*, note 108, at 547 and Carlton, K. and Fischel, H. (1983), *supra*, note 108, at 871 et seq..

¹³⁴ Scott, E. (1980), '*Insider Trading, Rule 10b-5, Disclosure and Corporate Privacy*', Journal of Legal Studies, Vol. 9, at 808 et seq. and Lorie, I. (1980), '*Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy: A Comment*', Journal of Legal Studies, Vol. 9, at 819 et seq..

benefit from the reward, as when he tips information to a third party for example.¹³⁵ Thirdly, the belief that a person with entrepreneurial skills who is not allowed to trade on inside information will join another profession does not accord with reality. Finally, the company of which he is an insider does not reward an insider but by the shareholders and others who trade with him and at whose expense an insider would make a profit. Therefore if this is left unregulated, it will cause a lack of confidence by the public, who will be unwilling to invest as minority shareholders in public companies.

The role of regulation can be viewed as a means of control. However, in justifying its use it must be proven that it facilitates the common good in providing a stable and structured environment that is free from hindrance. Only then can further provisions be used to enforce such aims. During the last three decades there has been an increased movement towards prohibiting insider dealing and manipulative practices by harmonising securities laws in a bid to establish a common international commercial morality. However, there are those who believe that this orthodox view is wrong. This poses the question as to which is of the '*right*' opinion.

One of strongest views put forward against insider dealing and manipulative practices is that they discourage investment. The main thrust of this argument is that if investors perceive that they are being unfairly treated they will lose confidence¹³⁶ in the integrity of the market.¹³⁷ This is of paramount importance since confidence in

¹³⁵ Loss, L. (1970), '*The Fiduciary Concept as Applied to Trading by Corporate 'Insiders' in the United States*', Modern Law Review, Vol. 33, at 36.

¹³⁶ "... [T]he main (if not only) convincing justification for controlling insider dealing is that it has a perceived, adverse impact on confidence..."

, Rider, B.A.K. and Ashe, T.M. (1993), *supra*, note 73, at 5 *et seq.*

"... We are trying to clean up and strengthen the markets, to make people who go and deal in quoted securities or securities that are available for dealing on the public market have more confidence in that market..."

, *Parliamentary Debates* 1979/80, 1 Standing Committee 'A', at column 610.

¹³⁷ "... [T]he main (if not only) convincing justification for controlling insider dealing is that it has a perceived, adverse impact on confidence..."

, Rider, B.A.K. and Ashe, T.M. (1993), *supra*, note 73, at 5 *et seq.*

a market increases trade and investment that in turn provides economic stability¹³⁸ at both a national and international level.¹³⁹ Good business ethics therefore need to be supported and reinforced by legal regulation for this reason.¹⁴⁰

Insider and manipulative activities has been perceived as being inherently unfair,¹⁴¹ as insiders have an unfair advantage, concentrating their activities around information that is not freely available to others.¹⁴² Manipulative practices seek to

“... We are trying to clean up and strengthen the markets, to make people who go and deal in quoted securities or securities that are available for dealing on the public market have more confidence in that market...”

, Parliamentary Debates 1979/80, 1 Standing Committee ‘A’, at column 610.

¹³⁸ *Report of the Task Force on Regulation of Insider Trading*, (1981) 41 *Business Lawyer*, at 285; Wu, J. (1968), ‘*An Economist looks at s.16 of the Securities Exchange Act 1934*’, *Columbia Law Review*, Vol. 68 at 263 *et seq.*; Berle, H. (1938), ‘*Liability for Stock Market Manipulation*’, *Columbia Law Review*, Vol. 38, at 393 and Ausubel, F. (1990), ‘*Insider Trading in a Rational Expectations Economy*’, *American Economic Review*, Vol. 80, at 1025 *et seq.*

¹³⁹ Rider, B.A.K. (1988), ‘*Policing the City*’ (1988) *Current Legal Problems*, at 47 and Rider, B.A.K. and Ffrench, H.L. (1979), *The Regulation of Insider Trading*, London: Macmillan, at 2.

¹⁴⁰ Goodhart, J. (1952), *English Law and the Moral Law*, in Borrie, G. Sir (1987), ‘*Law and Morality in the Market Place*’, *Journal of Business Law*, at 433:

“... Law generally approves and reinforces what is generally accepted as good behaviour in the society in which it operates and disapproves and penalises what is regarded as bad moral behaviour, such as sexual immorality, dishonest and unfair dealing. But there is no exact correspondence between law and accepted morality...”

¹⁴¹ See *Government White Paper on Company Law Reform*, Cmnd. 5391, at paragraph 16 and *Attorney General’s Reference* [No. 1 of 1988] (1989) BCLC, at 198, *per Lord Lane* were insider dealing was seen as nothing more than ‘cheating’. Indeed, Rider, B.A.K. and Ffrench, H.L. (1979) noted that:

“... public opinion in general considers [it] immoral and unethical...”

, The Regulation of Insider Trading, London: Macmillan, at 2. However, White, E. (1974) finds it ‘surprising’ that nowhere in this body of literature was there any justification for the prohibition of insider dealing beyond broad appeals to ‘commercial morality’; ‘*Towards a Policy Basis for the Regulation of Insider Dealing*’, *Law Quarterly Review*, Vol. 90, at 494. The notion of fairness has also been extremely prevalent in the United States; Schotland, T. (1967), ‘*Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*’, *Virginia Law Review*, Vol. 53, at 1438 *et seq.* and Heller, R. (1982), ‘*Chiarella, SEC Rule 14e-3 and Dirks: ‘Fairness’ Versus Economic Theory*’, *Business Lawyer*, Vol. 37, at 521 *et seq.*

¹⁴² *White Paper on The Conduct of Company Directors*, (1977) Cmnd. 7037, paragraph 22, at 6:

“... Public confidence in directors and others closely associated with companies requires that such people should not use inside information to further their own interests...”

undermine the free flowing of market information by placing inaccurate information in it that can be used to the manipulator's advantage. In the past such practices have gone unchallenged, given that lower ethical standards existed.¹⁴³ However moral concern can be seen to have played a part in the forging of laws used against such practices.¹⁴⁴ Generally, both practices go against the principles of market egalitarianism.¹⁴⁵ Thus, in order to make such markets fair these practices must be eradicated in order to allow all the parties connected with a transaction to have equal access to information¹⁴⁶ that is material to any investment decision made.¹⁴⁷ Consequentially, if the same information is available to all it prevents the exploitation of unearned information.

Yet, these concepts have been criticised on a number of grounds.¹⁴⁸ Firstly, it ignores the fact that obtaining market information can be an expensive exercise. Thus, in providing such information to market recipients it fails to explain what price,

143 Robb, G. (1992), *White-Collar Crime in Modern England, Financial Fraud and Business Morality, 1845-1929*, Cambridge: Cambridge University Press, at 131.

144 "... Laws generally approves and reinforces what is generally accepted as good moral behaviour in the society in which it operates and disapproves and penalises what is regarded as bad moral behaviour, such as sexual immorality, dishonest and unfair dealing. But there is no exact correspondence between law and accepted morality..."

, Goodhart, J. (1952), *English Law and the Moral Law* in Borrie, G. Sir (1987), 'Law and Morality in the Market Place', *Journal of Business Law*, at 433.

145 Brundney, V. (1979), 'Insiders, Outsiders and Informational Advantages under the Federal Securities Laws', *Harvard Law Review*, Vol. 93, at 339 *et seq.* and Bhattacharya, I. and Spiegel, G. (1991), 'Insiders, Outsiders, and Market Breakdowns', *Review of Financial Studies*, Vol. 4, at 256 *et seq.*

146 Lowery, D. (1989) 'International Approach to Insider Trading; The Council of Europe Convention', at 460. See *S.E.C. v. Texas Gulf Sulphur Co.* [2d Cir, 1968], at 848:

"All investors should have equal access to the rewards of participation in the securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical risks.... [I]nequalities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life."

147 Easterbrook, A. (1981), 'Insider Trading, Secret Agents, Evidentiary Privileges and the Production of Information', *Supreme Court Review*, at 323 *et seq.*

148 Ashe, T.M. and Counsell, L. (1993), *supra*, note 73, at 19-20.

if any, should be set to provide such a service.¹⁴⁹ Secondly, the concept of fairness also presupposes that all market participants will be placed on an even footing, discounting those who possess superior market trading instincts and/or an ability to accurately analyse market information.¹⁵⁰ Interestingly, the concept of fairness is often subdivided into two categories: one is procedural, which encompasses the methods which market participants use to negotiate and formulate transactions,¹⁵¹ and substantive fairness, which relates to the outcome, or substantive content, of transactions.¹⁵² Finally, there are some that believe that this argument also fails to distinguish between legitimate and illegitimate exploitation of market information.¹⁵³

From an economic standpoint, the object of regulation is seen to impose limits upon the variety of actions individuals or institutions can pursue. Thus, by limiting these actions through regulation, different outcomes emerge than would normally be achieved through the operation of unregulated, spontaneous market forces.¹⁵⁴ The crux of this argument in promoting regulation centres upon the belief that it curbs any ‘*unattractive characteristics*’ that a spontaneous market may produce, such as the

¹⁴⁹ Carlton, K. and Fishel, H. (1983), *supra*, note 108, noted:

“... *If it known that insiders cannot trade, the gains from discovering non-public information would be high and brokers would have an incentive to expend resources to uncover it. In fact the only effect a ban on insider trading might have is that brokers rather than insiders reap the gains from inside information. While this may be inefficient because brokers can only become informed at a high cost, the informed/uninformed trader problem remains. Smart brokers pose the same problem as smart insiders...*”

¹⁵⁰ Scott, A. (1980), ‘*Insider Trading, Rule 10b-5, Disclosure and Corporate Privacy*’, *Journal of Legal Studies*, Vol. 9, at 805. On the connection between justice and fairness see Orts, P. (1993), ‘*The Complexity and Legitimacy of Corporate Law*’, 50 *Washington and Lee Law Review*, Vol. 50, at 1604 *et seq.*

¹⁵¹ Leff, R. (1967), ‘*Unconscionability and the Code – The Emperor’s New Clause*’, *University of Pennsylvania Law Review*, Vol. 115, at 487 *et seq.* and *Hart v. O’Connor* [1985] AC 1000 (PC) at 1017 *et seq.*, *per Lord Brightman*.

¹⁵² Smith, ‘*In Defence of Substantive Fairness*’, (1996) 112 *Law Quarterly Review*, at 140 *et seq.*

¹⁵³ On justifying insider trading regulation on the basis of informational advantages, see Schepple, ‘*It’s Just Not Right ’’: The Ethics of Insider Trading*’, (1993) 56 *Law and Contemporary Problems*, at 160 *et seq.*

¹⁵⁴ Bowles, K. (1982), *Law and Economy*, London: Macmillan, at chapter ten.

susceptibility of a free financial market to fraud, manipulation and deception.¹⁵⁵ and acts as a device influencing economic activity and bringing about an acceptable and desired outcome from that generated by a spontaneous market. *Posner*¹⁵⁶ draws upon two theories to explain economic regulation. These relate to both public and private interest theories. The former purports that regulation is supplied in response to public demand to correct inefficient or inequitable markets.¹⁵⁷ Regulation is seen as being for the benefit and protection of the public as a whole rather than for the benefit of sectional interests. The latter theory rejects this on the grounds that correction of market imperfection is the goal of regulation.¹⁵⁸ Regulation, in this context, can be viewed as part of an economic/political process in which competing groups seek to promote their own interests.

155 *Op. cit.*, at 169.

156 See generally Posner, N. (1974), '*Theories of Economic Regulation*', *Bell Journal of Economics and Management Science*, Vol. 5, at 546.

157 Beck-Dudley, C.A., Caryn, R. and Stephens, M. (1989), '*The Efficient Market Theory and Insider Trading: Are We Headed in the Right Direction?*', *American Business Law Journal*, Vol. 27, at 446 *et seq.*

158 Stigler, G.J. (1975) believes that, after a time, regulating agencies tend to identify with the problems of the people they should be regulating and eventually end up protecting them rather than the public; *The Citizen and the State*, New York: Little, Brown and Co. This view is also accepted by Utton, N. (1986), '*The Economics of Regulating Industry*', New York: Little, Brown and Co, at 22. He suggests that:

“... in the 'mature' regulated industry... regulation will be seen to work in favour of the members rather than correct a market failure...”

2.4. *Summary*

This chapter draws attention to a number of important areas that underpin the structural, legal and theoretical aspects of market regulation. The structural issues exemplify the similarities and differences in the ways both the United Kingdom and United States have sought to regulate their own markets. In this respect, it can be observed that the present structure of financial regulation adopted in the United Kingdom is to evolve into a regulatory framework not unlike that used in the United States. The underlying reasoning behind this can be identified with the general failure of the City to adequately police itself effectively and the possibility of conflicts of interest arising out of the present structure imposed. Yet it can be perceived that by superimposing other ideas derived from the latter jurisdiction, potential problems rather than successes are likely to result in effectively combating these types market abuse.

While it can be acknowledged that the notion of disclosure is needed if any form of regulation is to be implemented, the degree to which it is to be enforced is disputed. Some advocate that a liberal regime of voluntary disclosure based on market forces is desirable while others argue that such a régime needs to be mandatory. Both viewpoints present positive and negative aspects. The same can be said to apply to those who seek to oppose or propose regulating insider dealing and market manipulation. Yet, given the validity of all the arguments presented, it needs to be said that both these types of market abuse need to be successfully regulated. Therefore, the arguments that propose mandatory disclosure and the need for regulating against insider dealing and market manipulation provide the strongest arguments in favour of encouraging the primary goal of market growth through facilitating investor confidence and market integrity.

Section Two

The aims of this section, which incorporates chapters three and four, is to critically examine the appropriateness of the legislative and common law approaches used in the United Kingdom that deal with insider dealing and market manipulation. This is achieved through comparative analysis predominantly with the United States, although other jurisdictions are used to a lesser extent, to assess whether the types of law utilised in this country can be made more effective in combating and deterring these types of market abuse. To this end, the criminal law will be examined to assess its appropriateness for penalising both. The possibility of more suitable and effective remedies in the form of the civil law is evaluated in conjunction with the possible problems that may be encountered if implemented.

Chapter Three

Regulating Insider Dealing

Overview

The consensus that can be drawn from the previous chapter is that insider dealing needs to be regulated. Yet, what are the best ways of achieving this desirable goal? This chapter argues that using comparative analysis the legislative and common law approaches adopted in the United Kingdom are inappropriate in effectively penalising this activity.

The aims of this chapter are threefold. Firstly, to briefly examine the conflicting reasoning behind the introduction of insider dealing legislation and identify the difficulties faced in determining its true extent. Secondly, through the use of comparative analysis, to examine the legal mechanisms used to regulate insider dealing in this country and the United States to assess whether the latter can offer any guidance to the former. Finally, to propose that the use of the civil and the administrative law would provide more appropriate forms of penalty and deterrence in conjunction with an examination of the possible problems this type of law may encounter, if implemented.

3.1. *Conflicting Ideas, Statistics and Insider Dealing*

Although anecdotal evidence exists suggesting that insider dealing is widespread¹ there is little positive evidence to provide a truly realistic picture. Since insider dealing did not become a criminal offence in the United Kingdom until 1980,² it would be reasonable to expect references to such activities before this time to be commonplace. In fact, this was not the case, for the detection,³ let alone the publication, of such incidences has been sporadic at best. Nineteen years on the picture is still far from clear, although media attention now seems tame compared to the 1980s,⁴ when capitalist attitudes enmeshed with the ideals of insider dealing, sensationalising and bringing to the public's attention ideas of a mysterious and often misunderstood activity.⁵ Understandably, it also cast a shadow over City practices,

¹ Farmery, J.(1987), '*Towards a tougher Regime Against Insider Dealing*', (December) *Business Law Review*, at 283; Pope, E., Morris, D. and Peel, K. (1990), '*Insider Trading: Some Evidence on Market Efficiency and Directors Share Dealings in Great Britain*', *Journal of Business Finance and Accounting*, at 259 *et seq.*; Reichman, N. (1993), '*Insider Trading*', at 56 *et seq.* in Tonry, M. and Reiss, A.J. Jr (eds.) (1993), *Beyond the Law: Crime in Complex Organisations*, Chicago: University of Chicago Press and Ashe, T.M and Counsell, L. (1993), *Insider Trading*, London: Fourmat Publishing, at 25 - 26.

² Prior to Part V of the *Companies Act 1980*, sections 68-73, legislative means of curtailing insider dealing was limited to disclosure provisions contained in general companies legislation.

³ Rider, B.A.K. (1995) has long advocated that those insiders that are detected are usually unlucky, unsuccessful at covering their tracks or are '*sacrificed*' by the city itself; '*Enforcement of Financial Services Law with Reference to Insider Dealing*' in Rider, B.A.K. and Ashe, T.M. (eds.) (1995), *The Fiduciary, the Insider and the Conflict - A Compendium of Essays*, Dublin: Brehon Sweet and Maxwell, at 199.

⁴ Nisse, H. (1996), '*Insider Alert after Heavy Trading in Blenheim Shares*', *The Times*, 1/6/96 and '*A Case to Answer at Caradon*', *The Times*, 19/1/96. Although Ashe, T.M. and Counsell, L. (1993), *supra*, note 1, suggest that it was during the early 1970's that initial media attention and public resentment grew, at 5. Interestingly, the DTI has now closed the *Caradon* case. This, in some respects, typifies the knee-jerk reaction of City regulators when insider dealing has allegedly occurred. It also emphasises the problems faced in bringing an investigation to court; Nisse, H. (1998), '*DTI Ends Caradon 'Insider' Inquiry*', *The Times*, 21/3/98.

⁵ Naylor, J.M. (1990(a)), '*The Use of Criminal Sanctions by the United Kingdom and United States Authorities for Insider Trading: How can the Two Systems Learn from Each Other*', *Company Lawyer*, Vol. 11, No. 5, at 53.

although Parliament in the 1970s was blatantly oblivious as to the extent of insider dealing.⁶ The general belief was that it was frequent:

“... it is hard to determine the extent of insider dealing. There are those who would argue ... that if there were much closer scrutiny it could open a can of worms...”⁷

However, because of intensified public debate and City concern during this period the City Panel on Take-overs and Mergers was established. The reason for implementing the regulation of take-overs was justified because it had long been accepted that insider activities had taken place during such ventures, as the value of price sensitive information was at it highest.⁸ The enactment of the Panel represented the first, albeit ineffective,⁹ step of what was to become the formal regulation of the United Kingdom's market place.

While it can be generally asserted that a Pandora's box exists regarding today's markets, the extent of the prevalence of insider dealing cannot be accurately

⁶ *House of Commons Parliamentary Debates* 1973/74, volume 867, at columns 925 (Mr Peter Walker), 967 (Mr Emlyn Hooson), 969 (Mr David Mitchell) and 983 - 984 (Mr Nicholas Ridley) and Suter, J. (1989), *The Regulation of Insider Dealing in Britain*, London: Butterworths, at 374.

⁷ *Companies Bill*, 22/10/79, at column 94 (Mr Bruce George).

⁸ Keown, J. and Pinkerton, I. (1981), 'Merger Announcements and Insider Trading Activity: An Empirical Investigation', *Journal of Finance*, Vol. 36, 857 *et seq.*; Rider, B.A.K. (1983), *Insider Trading*, London: Jordans, at 179 *et seq.*; Gupta, P. and Misra, H. (1988), 'Illegal Insider Trading: Is It Rampant before Corporate Takeovers', *Financial Review*, Vol. 23, at 454; Gupta, P. and Misra, H. (1989), 'Public Information and Pre- Announcement Trading in Takeover Stocks', *Journal of Economics and Business*, Vol. 41, at 225 *et seq.*; John, G., John, P. and Mishra, T. (1990), 'Information Content of Insider Trading around Corporate Announcements: The Case of Capital Expenditures', *Journal of Finance*, Vol. 45, at 836 *et seq.*; Rosenbaum, L. and Bainbridge, P. (1988), 'The Corporate Takeover Game and Recent Legislative Attempts to Define Insider Trading', *American Criminal Law Review*, Vol. 26, at 229 *et seq.* and Elliot, I., Morse, G. and Richardson, D. (1984), 'The Association Between Insider Trading and Information Announcements', *Rand Journal of Economics*, Vol. 15, at 522 *et seq.*. See also Department of Trade and Industry, 'Government Ends Advance Notice to Monopolists Named in MMC Reports', 21/12/98; *Competition Act 1998 s.69*; *Competition Act 1998 (Commencement No.2) Order 1998* and Edgecliffe-Johnson, N. (1998), *Takeover Panel Curbs Adviser Share-Buying*, *The Financial Times*, 22/7/98.

⁹ This was largely because the City Code that was adopted by the Panel was implemented through voluntary agreement; Rider, B.A.K. (1983), *supra*, note 8, at 181 *et seq.*

determined as statistical evidence is thin on the ground. This problem is further exacerbated by the fact that surveys made into this area have tended to be conducted over short time periods using only small samples. Therefore how significant these figures are is debatable given that rumours or market speculation, which may have interfered with the data interpretation, may have distorted them.¹⁰

Yet, insider dealing is not a new phenomenon. *Naylor* makes note of its existence as far back as the seventeenth century.¹¹ *Rider* has commented on numerous occasions of its existence during the nineteenth and twentieth centuries.¹² Indeed it was noted in the 1940s under the *Cohen Committee Report on Company Law Amendment* that insider dealing was widespread in the Stock Exchange.¹³ Moreover, it was often seen as a '*fringe benefit*' for those in the City offering a bonus for what many perceived as mundane duties.¹⁴ Interestingly, the type of individual who trades or has traded on inside information has not necessarily been directly associated with the markets themselves.¹⁵

¹⁰ Ashe, T.M. and Counsell, L (1993), *supra*, note 4, at 25 and Rider, B.A.K. (1983), *supra*, note 8, at 1. Brannon suggests that:

“... the truth is that neither the Department of Trade, nor the Stock Exchange, nor the American SEC, nor the most well-versed stockbroker knows just how frequently or infrequently insider trades do take place...”

; '*Insider Trading - The British Regulation in the Light of the American Experience*'; (1982) *Journal of Business Law*, at 344.

¹¹ Naylor, J.M. (1990(a)), *supra*, note 5, at 55.

¹² Rider, B.A.K. and Ffrench, H.L. (1979), *The Regulation of Insider Trading*, London: Macmillan, at 190 *et seq.*; Rider, B.A.K. (1991), '*Policing Insider Dealing in Britain*', at 313 *et seq.* in Hopt, K. and Wymeersch, E. (eds.) (1991), *European Insider Dealing*, London: Butterworths, and Rider, B.A.K. (1988), '*Policing the City - Combating Fraud and Other Abuses in the Corporate Securities Industry*', *Current Law Review*, at 63 *et seq.*

¹³ *Report of the Committee on Company Law Amendment*, (1945) Cmnd 6659, at paragraph 12679 *et seq.*

¹⁴ Fishman, L.J. (1993), '*A Comparison of Enforcement of Securities Law Violations in the United Kingdom and the United States*', (1993) 14 *Company Lawyer*, at 169.

¹⁵ Naylor, J.M. (1990(a)), *supra*, note 5 at 54; Ashe, T.M. and Counsell, L. (1993), *supra*, note 4, at 5; Robb, G. (1992), *White-Collar Crime in Modern England. Financial Fraud and Business Morality, 1845 - 1929*, Cambridge: Cambridge University Press, at 45 *et seq.* and '*Company News in Brief*', *The Independent*, 27/2/97.

Until 1980 insider dealing was deemed by many as an acceptable market practice both here¹⁶ and in the United States.¹⁷ The underlying reason for this lay in multitude of factors. These included the ambivalent attitude of those engaged in market affairs; lack of political will to force change because of market resentment; the ambiguity associated with the nature of insider dealing being perceived as a true ‘*criminal*’ offence and uncertainty as to its prevalence and how best to penalise and deter it.

The 1970s were turbulent times for the political fortunes of the Labour and Conservative parties with their opposing dogmas on company law reform.¹⁸ This essentially had a vast impact on the shape and direction which insider dealing should take. While the capitalist ideals by the Conservatives were used to underpin the *Companies Bill of 1973*¹⁹ this was viewed by the opposition as merely a ‘*public relations*’ exercise designed to win the forthcoming election.²⁰ By contrast, the Labour party sought to implement socialist policies to reform what they perceived as weak areas of company law in the *Companies Bill of 1978*.²¹

16 In the programme *Naked City*, BBC 2, 6/11/96, a former investment banker, Linda Davies, made the following observations:

“... In 1987 [I] was involved in a routine negotiation with a number merchant banks...the senior banker present suggested a course of action which was blatant insider trading. I suggested that....we were insiders and seventeen pairs of eyes glared at me, the senior banker who suggested it gave me a huge smile and said ‘your right we can’t do that’ and a lot of people in that room ...disliked what I had done ... because I had broken ranks...”

17 Rakoff, J. and Eaton, E. (1996), ‘*How Effective is United States Enforcement in Deterring Insider Trading*’, *Journal of Financial Crime*, Vol. 3, No. 3, at 285 - 286.

18 The *1973 Bill* outlined the Conservative government’s aim of facilitating free enterprise through the proliferation of wider share ownership; *House of Commons Parliamentary Debates 1973/74*, *supra*, note 5, at columns 1015 (Mr Bruce Gardyne) and 1041 (Sir Geoffrey Howe).

19 It was proposed that insider dealing should be made a criminal offence because of the unfair advantage it gave and the despondence expressed by some regulatory bodies in its sanctioning; *White Paper on Company Law Reform (1973)*, Cmnd 5391, at paragraph 15 *et seq.*

20 *House of Commons Parliamentary Debates 1973/74*, *supra*, note 5, at columns 964 (Mr Emlyn Hooson), 985 (Mr Michael Meacher), 997 (Mr William Rodgers) and 1014 (Mr Tom Dalyell).

21 *Commons Parliamentary Debates 1978*, volume 958, at columns 928 *et seq.* (The late John Smith).

Opposing ideology was not the only problem. The most effective means for dealing with insider dealing was also debatable. The *Cohen Committee*²² had recommended the use of disclosure requirements.²³ The *Jenkins Committee*²⁴ recommended the use of the civil law in situations where a director who used inside information should be liable to his company for any profit made and for damage suffered to the company.²⁵ While the *Justice Report* suggested that insider dealing should be made a criminal offence.²⁶

The United States, with its establishment of the *SEC*, *SEA* and *EA*, did not encounter the same conflict as experienced in the United Kingdom. However, it too had to rethink its strategy towards dealing with insiders. For many years, the sanctions available to the *SEC* for insider dealing were limited to injunctions and the disgorgement of profits in civil court actions and, in the case of a violation by a registered broker or dealer, *SEC* administrative disciplinary hearings. While criminal prosecution was a theoretical possibility, the difficulties of establishing intent beyond a reasonable doubt in such cases were considerable, and indeed, the first criminal prosecution of insider dealing in violations of the securities laws was not brought until 1978. Consequently, the amount of insider dealing until this period continued relentlessly. It was not until the sheer magnitude of such trading scandals was realised that specific legislation was enacted to increase the sanctions for both 10b-5 and 14e-3 violations, imposed affirmative oversight obligations on the securities industry, expanded the derivative liability of employers, and broadened the *SEC*'s powers of enforcement.

²² *Report of the Committee on Company Law Amendment*, (1945) Cmnd 6659.

²³ *Op. cit.* at paragraphs 86 and 87.

²⁴ *Report of the Company Law Committee*, (1962) Cmnd 1749.

²⁵ *Op. cit.*, at paragraph 90 *at seq.* and White, K. (1974), 'Towards a Policy Basis for the Regulation of Insider Dealing', *Law Quarterly Reports*, Vol. 90, at 502.

²⁶ *Justice Report, Insider Trading*, (1972), at paragraph 35 and Kay, M. (1973), 'The Justice Report on Insider Trading', *Modern Law Review*, Vol. 36, at 190.

3.2. Comparative Legislative Approaches to Insider Dealing

3.2.1. The United States' Approach to Insider Dealing

Insider dealing regulation in the United States is primarily based upon statute law,²⁷ this being achieved mainly through the provisions contained in the *SEA*. However, apart from prohibiting insiders from profiting by short swing dealings, the *SEA* neither originally prohibited nor defined insider dealing.²⁸ Nevertheless, insider dealing is generally identified as one of the many abuses that the *SEA* is designed to regulate.²⁹

The primary mechanism for insider dealing regulation in the United States can be found in section 10b *SEA*, through which rule 10b-5 was promulgated by the *SEC* in 1942.³⁰ These general anti-fraud provisions were principally designed to prohibit manipulative or deceptive practices, yet because of the general wording embodied in both section 10b-5 and rule 10b-5, the task of defining the parameters of each has largely been left to judicial innovation.³¹ Thus, both parts have indirectly become the pinnacle upon which civil cases involving insider dealing are based. Consequently,

27 Although common law actions were evident before the implementation of the *SEA*; Loss, L. (1995), *Fundamentals of Securities Regulation*, Boston: Little, Brown and Co, at 768-771 and Bauman, H. (1984), 'Comment: Insider Trading at Common Law', *University of Chicago Law Review*, Vol. 51, at 838 *et seq.*

28 Section 16 *SEA* was the first attempt by the United States to regulate insider dealing; Painter, N. (1967), 'Insider Trading and the Banker Director', *Banker's Magazine*, Vol. 150, at 31 *et seq.* and Agrawal, K. and Jaffe, J. (1995), 'Does Section 16b Deter Insider Trading by Target Managers?', *Journal of Financial Economics*, Vol. 39, at 295 *et seq.*

29 Bainbridge, P. (1986), 'The Insider Trading Prohibition: A Legal and Economic Enigma', *University of Florida Law Review*, Vol. 28, at 36 *et seq.* Also see *Ward La France Truck Corp.* [1943] 13 SEC 373; *Kardon v. National Gypsum Co.* [1947] 73 F. Supp. 798; *Speed v. Transamerica Corp.* [1951] 99 F. Supp. 808, 829; *Ernst and Ernst v. Hochfelder* [1976] 425 U.S. 185 rehearing denied 425 U.S. 986 and *Herman and Maclean v. Huddleston* [1983] 459 U.S. 375.

30 15 USC S 78j(b) [1982].

31 *Post.*

much of the jurisprudence relating to insider dealing in this country, has been fashioned by the courts rather than the legislature.³²

While the United Kingdom has not had any difficulty in defining insider dealing, due to the enactment of specific statutory measures, the United States has had problems in determining when insider dealing has occurred. Indeed, although the SEC has requested on numerous occasions that such a definition be formulated, Congress has always refused, on the grounds that it prevents the courts from using flexibility³³ in determining whether insider dealing has occurred or not.³⁴ Consequently, the SEC and judicial interpretation have produced working definitions of what amounts to insider dealing.³⁵ The courts, particularly in the 1980's, relied upon possession, fiduciary duty or abstention disclosure and misappropriation theories set in landmark cases to determine civil liability.

Early cases of insider dealing can be seen to have utilised the possession theory to determine insider liability. In such circumstances an insider's liability would be determined by the fact that he was in possession of material, non-public information and failed to either disclose it to other parties or abstain from dealing altogether. This theory revolved around the decision reached in *Re Cady, Roberts and Co.*³⁶ and

³² Ashe, T.M. and Counsell, L. (1993), *supra*, note 1, at 29.

³³ Although Congress did recognise in 1984 that:

“...the last few years have seen a dramatic increase in insider trading cases...”

Consequently, Congress enacted the *Insider Trading Sanctions Act 1984* which added this power to section 21(d)(2) SEA; H.R. Rep. No. 100-910, 100th Cong., 2d Sess 11 (1988). See also Bainbridge, P. (1985), ‘Note: A Critique of the Insider Trading Sanctions Act of 1984’, Virginia Law Review, Vol. 71, at 455 *et seq.*

³⁴ McVea, H. (1988), ‘A Compromise Proposal for the Regulation of Insider Trading’, Business Law Review, at 239 and Loss, L. (1995), *supra*, note 27, at 13 - 14, 27, and 31 - 33 *cf. Report of the Task Force on Regulation of Insider Trading. Part I: Regulation under the Antifraud Provisions of the Securities Exchange Act 1934*, (1985) 41 Business Lawyer, at 223 *et seq.* and 253 *et seq.*

³⁵ Naylor, J.M. (1990(a)), *supra*, note 5, at 83.

³⁶ [1961] 40 SEC 907.

subsequently approved in *SEC v. Texas Gulf Sulphur*.³⁷ The former case was concerned with a broker who had received inside information about a company's dividend from a fellow employee who was also a director of that company and used it. In the latter case officers and employees of a company made substantial purchases of that company's stock after learning that exploratory drilling on one of the company's properties showed promise of an extraordinary ore discovery. It can be derived from these cases that fairness or parity of information among market participants appeared to be the principle underlying the adoption of this theory.

Because the possession theory provided only a limited basis for defining insider dealing, later cases by the Supreme Court sought to redefine insider liability in more capacious ways, expanding liability to those not directly connected with inside information. Such an evolutionary step also marked a change of attitude for the Supreme Court as it had been up until this point wary to expanding the construction of securities laws, an antipathy born out of reaction to abusive lawsuits brought under rule 10b-5 by private litigants. Thus, in *Chiarella v. United States*³⁸ the Supreme Court rejected the possession theory and suggested that the duty to disclose or abstain existed only if it could be shown that:

“... a relationship of trust and confidence between the parties to the transaction...”

existed. *Chiarella* concerned a financial printer's employee who purchased stock of a company that was about to become the target of a hostile take-over by a company that was using the financial printer to prepare the secret tender offer documents. It was argued that even though the defendant was essentially an outsider this did not affect

37 [1968] 401 F.2d 833 (2d. Cir.) cert. denied [1969] 394 U.S. 976. Also see *Investors Management Co.* [1971] 44 SEC 633; *U.S. v. Teicher*, [1993] 987 F.2d 112 (2d. Cir.) and John, G. John, P. and Lang, P. 'Insider Trading around Dividend Announcements: Theory and Evidence', (1991) 46 Journal of Finance, at 1361 *et seq.*

38 [1980] 445 U.S. 222. See also Jarrell, K. and Poulsen, D. (1989), 'Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?', Journal of Law, Economics and Organization, Vol. 5, at 226 *et seq.*

the nature or basis of his liability as an insider.³⁹ In *Dirks v. SEC*⁴⁰ a case involving a tippee, the scope of liability was drawn in even narrower terms. This case revolved around an investment analyst, who having been informed by a company ‘whistleblower’ that the company was engaged in fraudulent accounting practices, advised his investment clients to dispose of the company stock. The Supreme Court decided that a tippee automatically inherited the tipper’s duty for the reason that the adoption of this proposition would advance the market egalitarianism theory. The Court made the tippee’s duty dependent on whether the tipper himself breached his duty to the company. Therefore, under this theory ascertaining an insider’s liability depended upon the purpose for which the information was passed on, and whether or not he benefited directly or indirectly from such a disclosure.

A principal shortcoming of the fiduciary theory is that it might enable persons lacking any special relationship to profit from the use of inside information. Nevertheless, the *SEC* has since pursued these individuals by relying on the misappropriation theory of rule 10b-5 liability, which up until recently solved a considerable number of the problems associated with some of the reasoning derived from *Chiarella*.

³⁹ Barry, N. (1981), ‘*The Economics of Outside Information and Rule 10b-5*’, University of Pennsylvania Law Review, Vol. 129, at 1308 *et seq.*

⁴⁰ [1983] 463 U.S. 646.

The misappropriation theory, as stated by *Burger C.J.*⁴¹ in *Chiarella*, applies in making an individual liable for insider dealing if he steals or misappropriates inside information from anyone to whom he owes a fiduciary duty also thereby commits a fraud by not disclosing the theft. The establishment of the *fiduciary-type* relationship requires a relationship of trust and confidence between the defendant and the source of the information.⁴² If he thereafter trades in securities on the basis of this inside information, he is guilty of a securities fraud, even if the ‘victim’ of the trading is not the victim of the theft of information, since all that is required of section 10(b) is that the fraud is ‘*in connection with*’ the purchase or sale of the security. It can be observed that this theory is more flexible than the abstention or disclosure one as it provides a slightly broader tippee liability in circumstances where an insider fails to breach a fiduciary duty.

While the misappropriation theory has, up until recently, received support from many of the Federal court of appeals for the Second, Third, Seventh and Ninth Circuits,⁴³ the Supreme Court has doubted its validity.⁴⁴ This position was originally reaffirmed in the decisions reached in *U.S. v. Bryan*⁴⁵ and *U.S. v. O’Hagan*.⁴⁶

41 [1980] 445 U.S., at 241, although it has been reaffirmed in subsequent cases; *U.S. v. Newman* [2d Cir. 1981] 664 F.2d 12; *SEC v. Materia* [2d Cir. 1981] 745 F.2d 197 and *U.S. v. Carpenter* [2d Cir. 1986] 791 F.2d 1024. See also Aldave, H. and Carroll, H. (1988), ‘*The Misappropriation Theory: Carpenter and Its Aftermath*’, Ohio State Law Journal, Vol. 49, at 375 *et seq.* and Beeson, F. (1996), ‘*Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*’, University of Pennsylvania Law Review, Vol. 144, at 1079 *et seq.*

42 *U.S. v. Grossman* [2d Cir. 1988] F.2d 78 and *U.S. v. Willis* [1990] 737 F. Supp. 269 (SDNY).

43 Gibeaut, T. (1997), ‘*The Real Insiders; SEC May Take Securities Trading issue to Supreme Court.*’, Alabama Law Journal, Vol. 83, at 42. See also, *SEC v. Cherif*, 933 F.2d 493 [7th Cir. 1991]; *SEC v. Clark*, 915 F.2d 439 – [9th Cir. 1990]; *Rothberg v. Rosenbloom*, 771 F.2d 818 [3d Cir. 1985] reversed on other grounds after remand, 808 F.2d 252 [3d Cir. 1986], cert. Denied., 481 US 1017 [1987]; *SEC v. Materia*, 745 F.2d 197 [2d Cir. 1984], cert. Denied, 471 US 1053 [1985]; *United States v. Newman*, 664m F.2d 12 (2d Cir. 1981), affirmed after remand, 722 F.2d 729 (2d Cir.), cert. Denied, 464 US 863 [1983]; *SEC v. Musella*, 578 F. Supp. 425 [SDNY 1984].

44 *United States v. Carpenter*, 484 US 19 [1987].

45 58 F 3d 933.

46 92 F 3d 612 [8th Cir. 1996]. See Coffee, N. (1997), ‘*O’Hagan, the Supreme Court Gets Second Chance to Adopt, and Define the Scope of, SEC’S ‘Misappropriation Theory’ of Insider*

However, it can now be regarded as suspect given the Supreme Court ruling in *O'Hagan*.⁴⁷ Its ruling effectively reverses the previous appeal courts verdict upholding the misappropriation theory as complementary to the fiduciary theory in forming the basis for convictions under Rule 10b-5. In addition, liability for insider dealing under Rule 14e-3, which deals with take-overs, was also seen as a legitimate use of the SEC's Rule making power under section 14(e). This essentially restores and clarifies what laws can be used to impose liability for insider trading.⁴⁸

Trading', National Law Journal, Vol. 19, No. 25, at 85 *et seq.*; Zirin, E. (1996), 'When is Immorality Considered Illegal?', *The Times*, 29/10/96; Tenoever, P. (1997), 'Insider Trading and the Dual Role of Information', Yale Law Journal, Vol. 106, No. 4, at 1326 *et seq.*; Blackman, K. (1997), 'The Death of the Misappropriation Theory', International Financial Law Review, Vol. 16, No.1, at 35 *et seq.* and Authers, H. and Waters, P. (1997), 'The Americas: SEC Win in Fight Against Insider Trade', *The Financial Times*, 26/6/97.

47 [1997] U.S. LEXIS 4033.

48 Alcock, A. (1997), 'Order Restored to United States Insider-Dealing Law', *Company Lawyer*, Vol. 18, No. 9, at 301 *et seq.*; McCoy, E. (1997), 'Supreme Courts Affirms Second Theory of Liability for Insider Dealing', *Company Lawyer*, Vol. 18, No. 10, at 225 *et seq.*; Alcock, A. (1997), 'Misappropriation Restored', *Journal of Business Law*, November, at 562 and Brodsky, J. (1997), 'United States Supreme Court Decides Landmark Insider Trading Case', *International Commercial Litigation*, at 48.

3.2.2. *The United Kingdom's Approach to Insider Dealing and the Effects of Europe*

The law on insider dealing in the United Kingdom has now been remodelled by Part V of the *Criminal Justice Act 1993*⁴⁹ (the 'CJA'). The provisions in the CJA repealed those previously contained in the *Company Securities (Insider Dealing) Act 1985* (the 'CSA')⁵⁰ and ensures that the United Kingdom complies with its obligations under European Community Law and, in particular, the *1989 EC Insider Dealing Directive (EEC 89/592)*.⁵¹

The *Directive* was adopted on 13th November 1989 by the Council of Ministers of the European Community for the purpose of co-ordinating regulations on insider dealing. The object of the *Directive* was to provide a minimum standard for the development of insider dealing laws throughout the Community.⁵² While identical laws were not required to be re-enacted by each Member State each was required to take adequate steps to comply with the *Directive*.

The underlying purpose of the *Directive*, which had been originally set out in the 1960s⁵³ and 1970s,⁵⁴ was to provide a basis for harmonising many of the differing

49 *Post*, sections 52-64 CJA. See generally Lomnicka, E. (1994), 'The New Insider Dealing Provisions: The Criminal Justice Act 1993, Part V', *Journal of Business Law*, at 173 *et seq.*; Wotherspoon, K. (1994), 'Insider Dealing – The New Law: Part V of the Criminal Justice Act 1993', *Modern Law Review*, Vol. 57, No. 3, at 419 *et seq.* and Mercer, E. (1995), 'Corporate Law and Finance in 1994' – A Busy Year', *Business Law Review*, Vol. 16, No. 1, at 2 *et seq.*

50 King, P. (1994), 'Insider Dealing v. The Criminal Justice Act 1993', *Compliance Monitor*, Vol. 7, No. 7, at 54 and Abrams, A. (1994), 'Insider Dealing – The New Regime', *European Financial Services Law*, Vol. 1, No. 1, at 7 *et seq.*

51 See generally Cranson, R. (1990), 'Insider Dealing Again', *Journal of Business Law*, at 444 *et seq.*; Davies, P. (1991), 'The European Community's Directive on Insider Dealing: From Company Law to Securities Markets Regulation', *Oxford Journal of Legal Studies*, at 92 *et seq.*; Ashe, T.M. (1992), 'The Directive on Insider Dealing', *Company Lawyer*, Vol. 13, No. 1, at 15 *et seq.* and Ross, E. (1992), 'Insider Trading: A U.K. Perspective within an E.C. Framework', *Compliance Monitor*, Vol. 4, No. 10, at 78 *et seq.*

52 Rider, B.A.K. and Ashe, T.M. (1995), *supra*, note 3, at 15 *et seq.*

53 Rider, B.A.K. and Ffrench, H.L. (1979), *supra*, note 12, at 263 *et seq.*

approaches adopted by Member States to provide a semi-unified approach in dealing with insider activities. Thus one of the key notions of the *Directive* related to the notion that improvements in the co-ordination of market standards and efficiency of corporate disclosure had to be ensured;⁵⁵ ideas that had been previously re-iterated. However, due to the complex nature of the problem of devising an all composing strategy against insider activities and the repercussions that substantive regulation might have throughout the field of corporate law implementation of the *Directive* was slow. Consequently, the implemented *Directive* bore little resemblance to the original one proposed. Therefore, restrictions relating to how insiders should be defined, what amounted to confidential information and how insider dealing should be enforced had to be clearly put in place before the *Directive* was implemented.

The *Directive* has had a vast impact on the moulding of the *Criminal Justice Act 1993*. For example, although other more flexible definitions exist as to what constitutes inside information, the United Kingdom has sought to closely follow that given in the *Directive*.⁵⁶ Likewise, it has followed a similar route when defining primary⁵⁷ and secondary insiders,⁵⁸ the range of activities that constitute insider dealing⁵⁹ and the range of securities affected by insider dealing.⁶⁰ Moreover, the United Kingdom has also sought to follow what defences a potential insider may have under the *Directive*.⁶¹ This, in many respects provided a fundamental leap forward

⁵⁴ Davis, P. (1991), *supra*, note 51, at 93 *et seq.*

⁵⁵ Prentice, D. (1991) (ed.), *EEC Directives on Company Law and Financial Markets*, at 2 *et seq.*; The Societas Europea Amended Proposal for a Regulation on the Statute for European Companies, European Communities Bulletin, Supplement 4/75 and also Employee Participation and Company Structures, *European Communities Bulletin*, Supplement 8/75.

⁵⁶ *SEC v. Texas Gulf Sulphur Co* 401 F2d 833 [2d Cir 1968]; *TSC Industries Inc. v. Northway* 426 US (1976) and *Ryan v. Trigueroff* [1976] 1 NSWLR 588.

⁵⁷ *Article 2* of the *Directive*.

⁵⁸ *Article 4, op. cit.*

⁵⁹ *Article 2, 3(a) and (b), supra*, note 57.

⁶⁰ *Article 1.2, supra*, note 57.

⁶¹ *Article 2.4, supra*, note 57.

for many other member states, as they have not until fairly recently, compared to the United States, taken action against such activities. France was the first with a Ordinance in 1967⁶² - Germany only had a self-regulatory system of control over insider dealing; this being introduced in 1970 - and Britain introduced legislation in 1980. Likewise the Netherlands only criminalized insider dealing in 1989 under *section 266a of the Penal Code* on 16/2/89.⁶³ However, despite the publicity surrounding the new legislation, it took Dutch authorities five years to launch their first prosecution in March 1994.⁶⁴

Of all the European jurisdictions the one with the closest links to the United Kingdom is the Republic of Ireland, whose principal companies have traditionally sought listing on the London Stock Exchange and have submitted to its regulatory requirements. However, the Irish Parliament passed the *Central Banks Act 1989* and the *Companies Act 1990*, which have increased the self-regulatory capacity of Irish markets under delegated central bank supervision. Under part V of the *1990 Act*, *section 111*, insider dealing gives rise to criminal liability, with maximum penalties under summary conviction of 12 months imprisonment and a fine of Irish £1,000; conviction on indictment can lead to 10 years imprisonment and a fine of Irish £200,000. More importantly though is the fact that Ireland has had the determination those in the United Kingdom do not and implemented civil liability for insider dealing under *section 109* of the *1990 Act*. However, despite the seeming flexibility of this enforcement regime there have not yet been any successful prosecutions for insider dealing in Ireland.

Italy has also signalled a recent change in enforcement attitude against insider dealing by passing on 7/5/91 *Law 157 of the Insider Dealing Act* which makes ‘...

62 Although this has recently been redefined. See McQuillan, S. (1996), ‘*Council Directive 93/22 on Investment Services in the Securities Field Law 96 - 597 of 2 July 1996 on investment Services*’, *International Company and Commercial Law Review*, Vol. 7, No.11, at 214 *et seq.*

63 Van den Bergh, E. (1997), ‘*The Netherlands*’, *International Financial Law Review*, Vol. 16, No. 7, at 96 *et seq.*

64 Oerlemans, H. (1996), ‘*Case Comment on Re Van Den Nieuwenhuyzen and Effects of Criminal Code Art.336a*’, *International Banking and Financial Law*, Vol. 14, No. 10, at 115 *et seq.*

equality of information for investors the objective.' Previously there had not been any specific provisions against insider dealing but prosecutors had made a handful of unsuccessful prosecutions against insider under the general rule of *Article 501* of the *Criminal Code*, which proscribed spreading false information regarding merchandise including listed securities. Maximum penalties under the *1991 Act* are fines up to 900,000,000 Italian lira and two years imprisonment. *CONSOB*, the country's companies and stock market watchdog, is the authority designed by Parliament to regulate against insider dealing but it has experienced difficulties in changing traditional Italian antipathy towards strict regulatory observance. Although insider dealing is acknowledged as widespread in Italy the first prosecution did not occur until March 1994. However, slow progress and corruption is entrenched in commerce and public life. Like recent judicial moves against the Mafia in Sicily and public corruption in Milan and Rome the *1991 Act* should be seen as a positive development on a difficult law enforcement programme.

As aforementioned Germany did not implement an insider dealing programme until 1970. The underlying reason for this was during the 1960's there were several insider dealing scandals that led to the introduction of voluntary guidelines in 1971. However, these guidelines proved '*very ineffective*' and there has been strong international criticism, especially from the United States concerning '*... the lax reputation of German Stock Exchanges.*' These were brought to a head by the well-publicised Steikuhlur scandal, which highlighted the deficiencies of the Voluntary Insider Dealing Guidelines. It also strengthened the arguments for the *Securities Trading Act 1994 (Wertpapierhandelsgesetz)*, which came into effect on 1/8/94.⁶⁵ Under its provisions convicted insider dealers face maximum penalties of up to five years imprisonment and large fines.⁶⁶ The *Act* places no upper limits on fines, but it does not provide for civil remedies and only individuals, not legal persons, can be

⁶⁵ Mahlich, F. (1997), '*Tackling Insider Trading in Germany*', International Commercial Litigation, November, at 26 *et seq.* and Mennicke, H. (1997), '*Insider Regulation in Germany: Inside Information, Insider Status and Enforcement*', European Financial Services Law, Vol. 4, No. 3, at 81 *et seq.*

⁶⁶ So far only fines have been levied, the largest being DM1m; Fisher, E. (1997), '*Insider Dealing Probe at Germany's SAP*', *The Financial Times*, 6/5/97.

held liable for insider trading. The urgent need for the legislation has been highlighted by recent revelations alleging a '*stock exchange mafia*' operating insider dealing rings on the Frankfurt Stock Exchange. Two dozen brokers are currently under investigation and co-operating with regulatory and tax authorities far having allegedly conspired in '*front-running*', but under current regulations the most severe sanction they face is cancellation of a broker's trading licence.

Former Eastern-bloc countries are also taking steps against insider dealing in their fledgling financial markets.⁶⁷ In February 1994 Hungary instituted strict penalties against insider dealing up to a maximum of three years imprisonment and the state securities supervisor has pledged to increase its investigative efforts. Russia is potentially the most important market in Eastern Europe. However, despite having privatised over half of its industry in the last two years its financial sector is in disarray. This disarray was dramatically illustrated by the collapse of the '*pyramid selling*' investment group MMM. Russia has the largest number of stock exchanges of any nation but it has the smallest number of shares traded on them. The MMM scandal has forced the Russian Government to address the problem of securities regulation, but there are no specific proposals for insider dealing regulation and it may take several years to produce a stable system of financial services regulation in Russia.

It can be seen that different European jurisdictions have taken varying approaches to tackling insider dealing.⁶⁸ United Kingdom and Irish law try to

⁶⁷ Blaha, A. (1997), '*Regulating the Czech Capital Market*', International Company and Commercial Law Review, Vol. 8, No. 2, at 52 *et seq.* and Dedek, J. (1994), '*Insider Trading, Investor Protection and an Orderly Capital Market: Lessons for the Czech Republic*', Prague Economic Papers, Vol. 3, at 201 *et seq.*

⁶⁸ Engelen, T. (1997), '*Is the Enforcement of Insider Trading Regulation Enforceable? A Critical Analysis of Five Years of Belgian Enforcement Policy of Insider Trading*', European Journal of Crime, Criminal Law and Criminal Justice, Vol. 5, No. 2, at 106 *et seq.*; Samuelsson, H. (1997), '*The Swedish Prohibition on Insider Trading – Insider Trading Act 1991*', European Financial Services Law, Vol. 4, No. 3, at 89 *et seq.*; Degenne, D. (1997), '*Developments in Swedish Securities Law*', European Financial Services Law, Vol. 4, No's. 11 and 12, at 296 *et seq.*; Valentin, C. (1995), '*Denmark: Supreme Court's First Insider Trading Judgment*', European Financial Services Law, Vol. 2, No. 9, at 262 *et seq.*; Bieger, I. and De Rojas, F. (1997), '*Council Directive 89/592 Co-ordinating Regulations on Insider Dealing Law 9/1991 of 22 March 1991 Amending the Securities Markets Law*', European Financial Services Law, Vol. 4, No's. 7 and 8, at 204 *et seq.*; Avgouleas, V. (1997), '*The Implementation of the Insider Dealing Directive in Greece*', European Financial Services Law, Vol. 4, No. 4, at 131 *et seq.* Dahan, K.

enumerate several offences while many European countries opt for a single offence whose elements are detailed in a single paragraph. France, Belgium, Luxembourg and Denmark are examples of the latter style. The European Community has sought to coordinate regulations and enforcement on insider dealing in different Member States through the Directive that combines English and French law.

The Directive is based on Article 100A of the Treaty of Rome, which is concerned with ‘... *the appropriation of laws.*’ The Preamble to the *Directive* states its objectives as ‘... *fairness and confidence in the market*’, and shifts the basis of the insider dealing ‘*wrong*’ from ‘*abuse of confidence*’ to ‘*inequality of information*’. Its definitions are sufficiently broad to accommodate the divergences of Member States’ laws and it lays the foundation for future co-operation in other fields of securities frauds.

However, *European Union Directives* can only represent a standard and levels of implementation may vary between Member States. Also, remedies are a matter of national law so there is an innate sense of abstention in the *Directive*. The case for legal persons being insiders and for civil liability, were put in debate in the European Parliament but they do not form part of the *Directive* and most Member States rely heavily on the Criminal law. However, there are potentially serious problems within the European Union regarding the *Directive* as the single market becomes more established and the regulatory differences between Member States more pronounced. These are issues for the future but to date it is clear, even allowing for the efforts of the European Union, no European jurisdiction has been as proactive against insider dealing as the United States.

(1997), ‘*The Impact of the 1989 EU Directive on Insider Dealing in France: Latest Developments*’, *European Financial Services Law*, Vol. 4, No’s. 7 and 8, at 194 *et seq.* and Serio, F. (1997), ‘*Insider Dealing in Italy*’, *European Financial Services Law*, Vol. 4, No’s. 7 and 8, at 201 *et seq.*

3.2.3. *The Criminal Justice Act 1993 – Operation and Limitations*

The effect of Part V of the *CJA* is to widen the potential scope of this type of offence, criminalizing those who either deal,⁶⁹ encourage⁷⁰ or disclose⁷¹ inside information, while at the same time clarifying a number of disputed points that existed under the old law. One of the most important aspects of the *CJA* was that it relinquished the need for the alleged insider to be ‘*knowingly connected with the company*’, which was a prerequisite for conviction under the *CSA*. Unfortunately, this was often successfully used by defence counsel to undermine a prosecution. The *CJA* also covers a wider range of securities, markets and persons who may be enmeshed in criminal liability.⁷² These and other changes can be summarised as follows:

- (a) the extension of ‘*inside information*’⁷³ to information that is price-sensitive⁷⁴ and not public⁷⁵ regarding any security;⁷⁶

69 Section 52(1).

70 Section 52(2)(a).

71 Section 52(2)(b).

72 Section 57.

73 Section 56. It has argued that the reliance on inside information casts a very wide net which could result in analysts who have detailed knowledge of a firm being ensnared under the *CJA*; Alcock, A. (1994), ‘*Insider Dealing - How Did We Get Here?*’, *Company Lawyer*, Vol. 15, No. 3, at 70 *et seq.* and Graham, G. (1998), ‘*Private Analyst Briefing may be Banned*’, *The Financial Times*, 29/6/98 *cf* *House of Commons Official Report of Standing Committee ‘B’*, 10/6/93, at columns 197 *et seq.*; Ham, H. (1995), ‘*City has the Last Word on Insider Dealing*’, *The Sunday Times*, 18/6/95; Jennings, P. and Smith, B. (1976), ‘*Insider Trading and the Analyst*’, *Institutional Securities Regulation*, Vol. 5, at 261 *et seq.* and Goldberg, T. (1998), ‘*Dealing from Within*’, *Company Secretary’s Review*, Vol. 22, No. 9, at 65 *et seq.*

74 Section 56(2).

75 Inside information therefore ceases to be so as soon as it is made public; *see generally* section 58. However, it has been suggested that such wording used in the *CJA* is advantageous to insiders as the information may not have been fully absorbed by investors and therefore insiders will have a ‘*head start*’; White, M. (1995), ‘*Insider Dealing and the Criminal Justice Act 1993*’ in Rider, B.A.K. and Ashe, T.M. (eds.) (1995), *supra*, note 3, at 62.

76 Schedule 2.

- (b) the extension of the scope of the definition of ‘*securities*’ to include new instruments;⁷⁷
- (c) the extension of the scope of ‘*regulated markets*’, subject to the legislation;
- (d) the extension of the scope of the territorial scope of the legislation;⁷⁸
- (e) the extension of liability to include off-market dealings relying on a professional intermediary;⁷⁹ and
- (f) the re-defining of defences⁸⁰

These issues will now be dealt with in more detail.

⁷⁷ In order to be caught, the securities must satisfy conditions laid down in the *Insider Dealing (Securities and Regulated Markets) Order*, S.I. No. 187/1994.

⁷⁸ Section 62 *CJA* states that there must be some connection with the United Kingdom in order for dealings to be caught. New powers under the *CJA* have come into force since June 1, 1999 making it possible for some offences to be prosecuted where an act or omission contributing to the commission of an offence takes place in England and Wales.

⁷⁹ Section 59(1).

⁸⁰ Section 53 and Schedule 1.

3.2.3.1. *Inside information*

In order for an individual to be classed as an insider they must use information that is none public, is in their possession and is price-sensitive. Inside information, therefore, must be information that relates to particular securities or issues of securities⁸¹ that are issued to an individual, public body or company.⁸² In addition, the information must also be specific or precise⁸³ and not mere rumour.⁸⁴ It must also not have been made public⁸⁵ but if it were to be made public it must be shown to have a significant effect on the price or value⁸⁶ of those securities being traded upon.⁸⁷ The requirement that information used is inside information is the central part in determining whether an individual or company is acting as an insider or not.⁸⁸

81 Section 56(1)(a).

82 Sections 60(3)(a) and (b) and section 60(4).

83 Section 56(1)(b) and *House of Commons Official Report of Standing Committee 'B'*, 10/6/93, at column 175.

84 *House of Commons Official Report of Standing Committee 'B'*, 10/6/93, at column 173.

85 Sections 56(1)(c) and 58.

86 Section 56(3).

87 Section 56(1)(d) and *House of Commons Official Report of Standing Committee 'B'*, 10/6/93, at column 178.

88 *House of Commons Official Report of Standing Committee 'B'* (1993), *op. cit.*, at column 172.

3.2.3.2. *Types of Securities*

Whereas the *CSA* covered only corporate securities and related derivatives the *CJA* covers a large number of previously unlisted securities,⁸⁹ which if need be can be amended.⁹⁰ These include all shares,⁹¹ debt securities⁹² including gilts and local authority stocks. Moreover, many other forms of derivatives are covered for the first time, including warrants,⁹³ depository receipts,⁹⁴ options,⁹⁵ futures⁹⁶ and contracts for differences⁹⁷ linked to shares or debt securities.⁹⁸

The issue of whether insider dealing actually occurs when ‘*contracts for differences*’ are involved has recently been intensively scrutinised, given Trafalgar House’s £1.2 billion bid for Northern Electric.⁹⁹ Trafalgar effectively bet that Northern’s share price would rise by striking a series of ‘*contracts for differences*’ with its investment banker, Swiss Bank Corporation. These derivative contracts allowed it to make a cash gain on the price rise without tipping its hand to the market

⁸⁹ Schedule 2.

⁹⁰ Sections 54(2), 64(1)-(3) and the *Insider Dealing (Securities and Regulated Markets) Order*, S.I. No. 187/1994.

⁹¹ Schedule 2, paragraph 1.

⁹² Schedule 2, paragraph. 2.

⁹³ Schedule 2, paragraph 3.

⁹⁴ Schedule 2, paragraph 4.

⁹⁵ Schedule 2, paragraph 5.

⁹⁶ Schedule 2, paragraph 6(1).

⁹⁷ Schedule 2, paragraph 7(1). In addition, see *City Index v. Leslie* [1992] 1 Q.B. 98 (C.A.) and Mercer, K. and Shilling, T. (1995), ‘*Pre-Offer Moves: Contracts for Differences*’, *Corporate Briefing*, Vol. 9, No. 6, at 2 *et seq.*

⁹⁸ *Insider Dealing (Securities and Regulated Markets) Order*, S.I. No. 187/1994, at article 8(a) and (b).

⁹⁹ Milner, M. (1995), ‘*Regulators to Look into £1.2 Billion Northern Electricity Take-over Bid*’, *The Guardian*, 13/1/95 and Beavis, S. (1995), ‘*Labour Queries Hostile Trafalgar Bid*’, *The Guardian*, 12/1/95.

by buying the actual shares. Under *schedule 2* of the *CJA* entering into ‘*contracts for differences*’ is treated in the same manner as buying underlying shares. But companies about to make a bid are not caught by the insider dealing rules if they deal in securities ‘*with a view to facilitating the accomplishment of the acquisition.*’ This clause was introduced into the original insider dealing regulations in 1980 to allow the normal practice of bidders buying small stakes in their target ahead of an offer. Although the debate whether Trafalgar House did actually commit insider dealing has been settled in their favour¹⁰⁰ there are many in the City who have contrary beliefs.¹⁰¹ Interestingly, the Trafalgar House incident not only highlights the ambiguous nature of insider dealing laws when applied to secondary share trading¹⁰² but also the difficulties and political pressures faced by the multitude of regulators investigating such matters.¹⁰³ It also illustrates the ineffectiveness of the general retroactive approach by British authorities.¹⁰⁴

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- 100 Beavis, S. and Whitebloom, S. (1995), ‘*Swiss Bank Cleared of Rule Breach*’, *The Guardian*, 19/1/95. The Swiss Bank Corporation were eventually fined by the SFA for failure to properly implement or control Chinese walls procedures in relation to take-over bids; Hunt, T. (1998) ‘*Insider Trading*’, *Amicus Curiae*, Vol. 5, at 20 *et seq.*. See also *Bolkiah v. KPMG* [1999] 1 WLR. 215 and ‘*The Men who Walk Through Walls*’, (1999) *Compliance Monitor*, Vol. 11, No. 9, at 145 *et seq.*
- 101 Wighton, E. (1995), ‘*Insider ‘Loophole’ in Trafalgar Bid*’, *The Financial Times*, 11/1/95.
- 102 Owen, E. (1996), ‘*Insider Dealing and Charges Over Securities*’, *International Business and Financial Law*, Vol. 15, No. 2, at 15 *et seq.*; Gapper, J. (1997), ‘*Banks Warned Over Secondary Trading of Loans*’, *The Financial Times*, 22/1/97; Peaton, T. and Wighton, E. (1995), ‘*SBC ‘May have Breached Insider Dealing Rules’*’, *The Financial Times*, 13/2/95 and ‘*Gobbledygook, Chinese Walls and the SIB*’, *The Independent*, 14/6/96. For comparative analysis on how insider dealing legislation (fails to) deals with derivatives see Malan, P. (1996), ‘*South Africa: Regulation on Insider Trading in Derivatives in South Africa*’, *Futures and Derivatives Law Review*, Vol. 3, No. 2, at 19 *et seq.*
- 103 Goodway, N. (1995), ‘*DTI Urged to Rule Soon on Swiss Bank*’, *The Observer*, 22/1/95; Peston, R. and Wighton, E. (1995) ‘*DTI Scans Swiss Bank Derivatives Dealings*’, *The Financial Times*, 20/1/95 and Wighton, E. and Cohen, N. (1995), ‘*SIB Warns on Special Derivatives*’, *The Financial Times*, 14/2/95.
- 104 Wighton, E. (1995), ‘*SE Might Change Rules Following Trafalgar Bid*’, *The Financial Times*, 14/1/95; Miller, R. (1996), ‘*SIB Acts to Close Takeover Loopholes*’, *The Times*, 14/6/96 and Graham, G. (1996) ‘*City Watchdogs Curb Use of Derivatives in Takeover Bids*’, *The Financial Times*, 14/6/96.

3.2.3.3. *Regulated Markets*

In order to be caught, the securities must satisfy conditions laid down in the *Insider Dealing (Securities and Regulated Markets) Orders*.¹⁰⁵ This states that a security must be officially listed in a state within the European Economic Area or admitted to dealing on, or have its price quoted on or under the rules of, a regulated market.¹⁰⁶ In the case of derivatives, the underlying shares or debt securities to which they relate must be dealt on a regulated market instead.¹⁰⁷

¹⁰⁵ *Insider Dealing (Securities and Regulated Markets) Order*, S.I. No. 187/1994 and *Insider Dealing (Securities and Regulated Markets) (Amendment) Order*, S.I. No. 1561/1996.

¹⁰⁶ Section 60(1); *Insider Dealing (Securities and Regulated Markets) Order*, S.I. No. 187/1994, at articles 2 and 4. *House of Commons Official Report of Standing Committee 'B'*, 10/6/93, at column 166.

¹⁰⁷ *Insider Dealing (Securities and Regulated Markets) Order*, S.I. No. 187/1994, at articles 5 - 8.

3.2.3.4. Territorial Scope

The 1994 *Order* identifies which markets are ‘*regulated in the United Kingdom*’ for the purposes of the territorial scope of the offence. These are markets established under the rules of the London Stock Exchange, LIFFE and OMLX.¹⁰⁸ There must be some connection with the United Kingdom to be caught¹⁰⁹ - either they take place on such a market,¹¹⁰ or the individual¹¹¹ or professional intermediary¹¹² is in the United Kingdom at the time.

3.2.3.5. Off-market Trading and Professional Intermediaries

Any deal that takes place off-market may well be caught under the *CJA* if the person dealing relies on a professional intermediary, or is himself acting as one.¹¹³ Under the *CJA* a professional intermediary is defined as any person who carries on a business or is employed in a business¹¹⁴ consisting of a particular activity and who holds himself out to the public or to any section of the public¹¹⁵ as being willing to engage in any such business.¹¹⁶ The activities in question are the disposing and acquiring of

108 *Insider Dealing (Securities and Regulated Markets) Order*, S.I. No.187/1994, at art. 10 and Schedule as amended by *Insider Dealing (Securities and Regulated Markets) (Amendment) Order*, S.I. No. 1561/1996, at articles 3 - 4.

109 Section 62.

110 Section 62(1)(b).

111 Section 62(2)(a).

112 Section 62(1)(c).

113 *House of Commons Official Report of Standing Committee ‘B’*, 10/6/93, at column 192 *et seq.*

114 Section 59(1)(b).

115 Section 59 and *House of Commons Official Report of Standing Committee ‘B’*, 10/6/93, at column 192.

116 Section 59(1)(a).

securities,¹¹⁷ either through acting as principal or as an agent, or acting as an intermediary between persons taking part in any dealing in securities.¹¹⁸

¹¹⁷ Section 54 and Schedule 2.

¹¹⁸ Section 59(2)(a) and (b).

3.2.3.6. Scope of Defences.

Under the *CJA* there are two broad types of defence- those that relate to behaviour that may be construed as insider trading and those that through market conditions may be classed as insiders.

Under section 53 four defences are available to a defendant, each of which relates to the defendant's mentality when trading. Therefore, if the defendant can show that at the trading he had no expectation of profit or avoidance of loss,¹¹⁹ believed that the information which he had relied upon was had already been freely distributed,¹²⁰ was doing what he would have done anyway¹²¹ or did not believe any one would deal in the securities because of the disclosure of the inside information,¹²² he will not have committed an offence under the *CJA*.

Other defences are available under Schedule 1 the *CJA* although these relate specifically to market conditions as opposed to potential insider dealing. Under the Schedule, market-makers¹²³ are granted special consideration given that by virtue of their position they may come into contact with inside information.¹²⁴ A market-marker therefore will be afforded a defence if he can show that he acted in accordance

¹¹⁹ Section 53 (6). This defence applies equally to the offences of dealing; section 53(1)(a), encouraging; section 53(2)(a) and disclosing; section 53(2)(b).

¹²⁰ Sections 53(1)(b) and 53(2)(b). This defence only applies to the offences of dealing and encouraging.

¹²¹ Sections 53(1)(c) and 53(2)(c). Again these defences only apply to the offences of dealing and encouraging. Also see *House of Commons Official Report of Standing Committee 'B'*, 10/6/93, at column 159.

¹²² Section 53(3)(a).

¹²³ Schedule 1 paragraph 1(2)(a) and (b).

¹²⁴ Although how they come into possession of such information is immaterial; *per* the Economic Secretary to the Treasury, Mr A. Nelson, *Standing Committee 'B'*, 15/6/93, at col. 216. This position dramatically contrasts with that taken under the *CSA* which required market-makers to obtain information by virtue of their position. This created a dilemma for the market-maker in that if he obtained inside information other than in the course of business and dealt on it he could attract criminal liability under the *CSA*, alternatively if he withdrew from dealing then this could draw notice to his movements; Ashe, T.M. and Counsell, L. (1993), *supra*, note 1, at 112.

with the rules of a regulated market¹²⁵ or approved organisation¹²⁶ when disposing or acquiring of securities of which he had inside price-sensitive knowledge. Hence, a market-maker will not be held liable of insider dealing through dealing in securities or encouraging another to deal if he can show that he acted in all honesty and good faith¹²⁷ in the course of his business as a market-maker or his employment in the business of the market-maker.

¹²⁵ Schedule 1 paragraph 1(2). '*Regulated markets*' are markets designated by Treasury Order; section 60(1) and the *Insider Dealing (Securities and Regulated Markets) (Amendment) Order*, S.I. No. 1561/1996.

¹²⁶ Schedule 1 paragraph 25B *FSA '86*.

¹²⁷ What will be determined by the courts as '*good faith*' will be assessed on the facts and surrounding circumstances.

3.3. *The Appropriateness of Using the Criminal Law in Insider Dealing Cases*

The sole use of the criminal law to prosecute insider dealing has been long advocated as the central reason for the ineffectiveness of the *CJA*. The rigid adherence to criminalizing insider dealing is a reflection of the former Governments staunch belief that it not only protected investors, facilitating market integrity¹²⁸ but also projected the notion of deterrence.¹²⁹ Yet, with its high burden of proof¹³⁰ intertwined with the need to show a causative *nexus* between the use of inside information and the damage caused,¹³¹ which given that most securities transactions are ‘*faceless*’ or ‘*victimless*’,¹³² further emphasises its unsuitability.¹³³ In the seventeen years since its implementation the criminal law on a purely cost/benefit basis has sustained a very poor performance record,¹³⁴ with the vast proportion of those pursued under it either being acquitted or given lenient sentences or fines.¹³⁵ Indeed, given that a large proportion of market abuses are orchestrated within organised rings that actively seek

128 Ashe, T.M. and Counsell, L. (1993), *supra*, note 1, at 131.

129 McBarnet, H. and Whelan, I. (1991), ‘*The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control*’, *Modern Law Review*, Vol. 54, No. 6, at 848 *et seq.*

130 Alcock, A. (1994), ‘*Insider Dealing - How Did We Get Here?*’, *Company Lawyer*, Vol. 15, No. 3, at 67.

131 Report of Standing Committee ‘B’, 15 June 1993, at column 207, *per* Economic Secretary to the Treasury.

132 *Ante*, chapter two, section three and Miller, R. (1996), ‘*Insider Dealing Under Notice*’, *The Times*, 9/9/96 and Bourne, J. (1989), ‘*Insider Dealing*’, *Business Law Review*, at 230 *et seq.*

133 *See generally*, Rider, B.A.K. (1985), ‘*Combating International Commercial Crime*’, *Lloyd’s Maritime and Commercial Law Quarterly*, Vol. 2, at 217; Rider, B.A.K. (1988), ‘*Policing the City - Combating Fraud and Other Abuses in the Corporate Securities Industry*’, *Current Legal Problems*, at 66; Rider, B.A.K. (1997), ‘*Does Insider Dealing Deserve the Regulatory Attention it Receives?*’, *European Financial Services Law*, Vol. 4, No. 3, at 74 and Dine, J. (1997), ‘*Insider Trading: The Why? And How?*’, (1997) 4(3) *European Financial Services Law*, at 75 *et seq.*

134 *Ante*, chapter one, section three.

135 *See generally* Geis, G. and Meier, R.F. (eds.) (1977), *White Collar Crime: Offences in Britain, Politics and the Professions - Classic and Contemporary Views*, New York: The Free Press and

to diffuse their activities through a myriad of trading transactions the chances of being detected, let alone prosecuted, are highly unlikely.¹³⁶ Consequently, given this and the fact that it is often utilised as a political scapegoat displacing accountable blameworthiness to other agencies or departments,¹³⁷ it is not surprising to find that many of those involved in prosecution of such activities believe that it should only be treated as a regulatory offence.¹³⁸

Yet, the failings of the criminal law cannot be solely attributed to its total unsuitability. Factors such as inadequate resources; attitude differences between prosecution and regulatory agencies involved; political pressures; lack of co-operation and evidential difficulties procured by the working parameters imposed by the *CJA* have all contributed to the failure of the criminal law.¹³⁹ The culmination of problems associated with this type of punishment explains why support for alternative forms of sanctioning in this area has grown.¹⁴⁰

Before the enactment of the *FSA '86* the only means from which civil redress for insider dealing could be had was through reliance on general common law principles.

Braithwaite, J. and Geis, G. (1982), '*On Theory and Action for Corporate Crime Control*', April, *Crime and Delinquency*, at 291 *et seq.*

¹³⁶ '*Developments in the Law: Corporate Crime: Regulating Criminal Behaviour Through Criminal Sanctions*', (1979) *Harvard Law Review*, Vol. 92, at 1365 *et seq.*; Ashworth, A. and Miller, R. (1996), '*Stock Exchange Sleuths on the Trail of Big Insider Dealing Rings*', *The Times*, 9/9/96 and Farrelly, J. (1997), '*Insider Probe Looks at Alpha Deals*', *The Independent*, 16/2/97.

¹³⁷ Levi, M. (1987), *Regulating Fraud: White Collar Crime and the Criminal Process*, London: Tavistock, at 48 *et seq.*

¹³⁸ Long, J. (1994), '*Policing the Markets*', *Company Lawyer*, Vol. 15, No. 3, at 83.

¹³⁹ The same problems in developing legislation that effectively tackles insider dealing head on seem to be repeated upon every new statutory enactment:

"...[the] offence of insider trading displays all the worst features of British Legislation in this sphere: very great complexity and specifically linked with numerous defences and loopholes, through which all but the most careless might expect to escape..."

¹⁴⁰ Bennett, P. (1994), '*What's Wrong with Insider Dealing?*', *International Company and Commercial Law Review*, Vol. 5, No. 9, at 299 *et seq.*; Clarke, M. (1990), *Business Crime: Its Nature and Control*, Milton Keynes: Open University Press, at 16 *et seq.* and Ashe, T.M. (1990), *Butterworths Journal of International Banking and Fiscal Law*, Vol. 5, No. 7, at 291 *et seq.*

These principles remain important because of the narrowness of section 61 and section 62 of the *FSA '86* that, in theory, provides a statutory remedy in case of an infringement of the *Authority's* rulebook.¹⁴¹ Since the *Authority's* rulebook applies only to a limited range of circumstances – confined to the regulation of financial intermediaries in the financial sector – the common law must still be looked at in order to gain the broader perspective of the law as it currently stands. In this respect the common law position in regard to face-to-face transactions must necessarily be considered first before going on to consider the position in relation to impersonal stock market transactions.

There are two main grounds at common law that may attract civil liability for anyone indulging in insider dealing. These relate to a breach of fiduciary duty and breach of confidence. Although various remedies for breach of fiduciary duties do exist, many uncertainties and difficulties lie in the path of a successful shareholder action, making it unlikely that this route will ever be used.¹⁴² In the case of a shareholder that wishes to sue a director who has inside information in breach of his fiduciary duties for example, *Percival v. Wright*¹⁴³ operates as a major obstacle. In this case it was held that directors only owe a fiduciary duty to their company¹⁴⁴ and

141 Financial Services Authority's Conduct of Business Core Rule 28 *Financial Services (Dedesignation) Rules and Regulations 1994*. Since the Authority has come in being there have been calls for new powers to combat insider dealing although it seems destined that these will largely materialise in the future; Graham, G. (1998), '*FSA to Get More Power to Tackle Insider Dealing*', *The Financial Times*, 7/5/98; Peston, R. and Eaglesham, T. (1998), '*FSA Faces Two Year Wait for Full Regulatory Powers*', *The Financial Times*, 1/6/98 and Miles, H. (1998), '*FSA to Target Firms Over Insider Trading*', *The Times*, 6/6/98.

142 Indeed, the term as to what is meant by fiduciary has equally been debated, it being suggested that it is one of the worst described terms in English law; Rider, B.A.K. (1983) *supra*, note 8, at 67. However, numerous definitions have been postulated; *Bray v. Ford* [1896] A.C. 44, at 51, *per Lord Heschell*; *Reading v. Attorney General* [1951] A.C. 507, at 516, *per Lord Porter*; *Boardman v. Phipps* [1967] 2 A.C. 46, at 123, *per Lord Upjohn*; *Diamond v. Oreamuno* 24 N.Y. 2d 494 [1969], at 496, *per Chief Judge Fuld*; *English v. Dedham Vale Properties Ltd.* [1978] 1 W.L.R. 93, at 110, *per Slade J.*; *Schein v. Chasen* 313 So2d 739 (1975) and *Freeman v. Decio* 584 F2 d 186 (1978)

143 [1901] 2 Ch 421 *cf. Coleman v. Myers* [1977] 2 NZLR 225, at 324, *per Woodhouse J.* and Finn, *Fiduciary Obligation*, (1977), at 67.

144 *Foss v. Harbottle* [1843] 2 Hare 461.

not its shareholders.¹⁴⁵ Although a '*special circumstances*' doctrine exists which provides an exception to the principle laid down in *Percival v. Wright*, it only covers insider dealing in face to face transactions and consequentially provides no remedy for those dealing in public markets.¹⁴⁶ Similarly, any action brought by the company against an insider is also beset with problems. For example, it is not entirely clear whether an insider who sells shares based on inside information that he has acquired by virtue of his position is liable to account if he sells in order to avoid a loss. A question mark also hangs over the issue of whether it is possible to ratify breaches of fiduciary duty, and if so, by what means the ratification is to be secured. In any case, there has been a distinct reluctance on the part of directors¹⁴⁷ to initiate actions on behalf of the company by suing fellow directors.¹⁴⁸

Finally, an action in the name of the company in the context of insider dealing means that any profits recouped go to the company and not directly to aggrieved shareholders.¹⁴⁹ Indeed, if the insider maintains a substantial shareholding he will

¹⁴⁵ *Regal (Hastings) v. Gulliver* [1967] 2 A.C. 134; *Industrial Development Consultants v. Cooley* [1972] 1 W.L.R. 443 and *Multinational Gas and Petrochemical Co. v. Multinational Gas and Petrochemical Services Limited* [1983] 2 All E.R. 563, at 585, per Dillon L.J.. Although note that a director may owe a duty to shareholders where he is appointed by the shareholders to act as their agent of an offeree company; *Allen v. Hyatt* [1922] 30 T.L.R. 444 and *Gething v. Kelner* [1972] 1 All E.R. 1166. Also see Prentice, D. (1975), '*Insider Trading*', (1975) Current Legal Problems, at 83.

¹⁴⁶ Hannigan, B. (1994), *Insider Dealing*, London: Kluwer, at 126.

¹⁴⁷ Although a director may pursue a business opportunity if:

- (i) the powers prescribed in the articles of association permit it (article 70 in Table A, *Companies Act 1985*);
- (ii) the members of the company give consent after full and frank disclosure of the facts (*New Zealand Netherland Society 'Oranje' Incorporated v. Kuys* [1974]); or,
- (iii) if the board decides not to pursue a venture then individual directors may pursue it (*Queensland Mines Ltd. v. Hudson* [1978] 52 A.L.J.R. 399).

¹⁴⁸ Usually the company will have to change ownership before directors will embark on such an line of action.

¹⁴⁹ Suter, J. (1989), '*The Regulation of Insider Dealing in Britain*', London: Butterworths, at 145.

indirectly benefit from the action against him.¹⁵⁰ Some of the problems, and others - most particularly the degree of knowledge required of 'tippees' - additionally to actions by the company against third parties (*tippees*) as constructive trustees.¹⁵¹ Likewise, a derivative action by a minority shareholder would face the formidable difficulty of showing that insider dealing was a fraud on the minority and that there existed wrongdoer control. Furthermore, problems regarding the cost of such litigation are enough to put all but the most dedicated shareholder from pursuing an action through the courts,¹⁵² although the use of contingency fee schemes may offer support for derivative actions.¹⁵³

It can also be noted that such a course of action on the part of the claimant has not received much in the way of support from the courts because such a claimant has to displace any evidential burden himself unless there has been a prior criminal prosecution. Thus, the onus of proof rests on the claimant to establish whether or not a breach of duty occurs.¹⁵⁴ It would seem that whilst a breach of a fiduciary duty in

150 *Justice Report on Insider Trading*, (1972), at paragraph 32 and Kay, M. (1973), 'The Justice Report on Insider Dealing', *Modern Law Review*, Vol. 36, at 191.

151 *Selangor United Rubber Estates Ltd. v. Craddock (No. 3)* [1968] 1 W.L.R. 1555; *Belmont Finance Corporation Ltd. v. Williams Furniture Ltd.* [1979] Ch 250; *Baden v. Societe General du Commerce SA* [1983] B.C.L.C. 325; *Naus Asia Co. Inc. v. Standard Chartered Bank* [1990] 1 H.K.L.R. 296; *Agip (Africa) Ltd. v. Jackson* [1991] Ch 547; *Sumitomo Bank Ltd. v. Kartika Ratna Thahir* [1993] 1 S.L.R. 735; *Eagle Trust plc. v. S.B.C. Securities Ltd.* [1993] 1 W.L.R. 484 and *Attorney General for Hong Kong v. Reid* [1994] 1 A.C. 324.

152 Suter, J. (1989), *supra*, note 6, at 160.

153 *Wallesteiner v. Moir (No. 2)* [1975] 1 All E.R., at 862, *per Lord Denning*.

154 "...it is well settled by authority of this House in *Cutler v. Wandsworth Stadium Ltd* [1949] AC 398, that the question whether legislation which makes the doing or omitting to do a particular act a criminal offence renders the person guilty of such an offence liable also in a civil action for damages at the suit of any person who thereby suffers loss or damage in a question of construction of the legislation..."

, Lord Diplock in *Lonrho Ltd v. Shell Petroleum Co. Ltd.* [1981] 2 ALL ER, 456 at 460d. Buckley, L. (1984), has also argued that:

"...the fiction that liability depends exclusively upon legislative intention should finally be abandoned. The courts should recognise that the decision whether or not to grant a civil action is ultimately one of policy for them..."

, 'Liability in Tort for Breach of Statutory Duty', *Law Quarterly Review*, Vol. 100, at 232.

company law is not without precedent¹⁵⁵, and may be applicable in certain investor legislation¹⁵⁶ it is doubtful whether the courts possess the impetus to pursue this matter any further than they have already ventured.

Alternatively, a civil common law action based upon breach of confidence may be brought against any one who is allegedly an insider.¹⁵⁷ However, in order for such an action to arise an obligation of confidence must exist, through confidential information¹⁵⁸ being divulged¹⁵⁹ or through the existence of an expressed or implied contractual agreement. Once this has been established it must be proven that this information was used in an unauthorised manner by one or more parties¹⁶⁰ to the detriment of the communicating party,¹⁶¹ although this point is still to be clearly decided.¹⁶²

Contextually, the use of unauthorised information means 'used' or 'disclosed',¹⁶³ whether intentional or not,¹⁶⁴ so as to cover both insiders and 'tipped'

¹⁵⁵ *Re: South of England Natural Gas and Petroleum Co Ltd.* [1911], 1 Ch 573 and *Woods v. Winkill* [1913] 2 Ch 303.

¹⁵⁶ *The Prevention of Fraud (investments) Act 1958* and the *Banking Act 1979*.

¹⁵⁷ See generally *Law Commission Report on Breach of Confidence*, (1981), Cmnd. 8338.

¹⁵⁸ *Terrapin Ltd. v. Builder's Supply Co (Hayes)* [1968] R.P.C. at 391, per *Roxburgh J.*

¹⁵⁹ *Lamb v. Evans* [1893] 1 Ch 218 and *Thomas Marshall (Exporters) Ltd. v. Guinle* [1978] 3 All E.R. 193.

¹⁶⁰ Although if large numbers of individuals are given access to such information at the same time the element of confidentiality may be lost; *Dunford and Elliott Ltd. v. Johnson and Firth Brown Ltd.* [1977] 1 Lloyd's Rep. 505.

¹⁶¹ *Coco v. A. N. Clark Engineers Ltd.* [1969] R.P.C. 41, at 48, per *Megarry J.*

¹⁶² *Attorney General v. Guardian Newspapers Ltd. (No. 2)* [1988] 3 All E.R. 545.

¹⁶³ *Saltman Engineering Co. Ltd. v. Campbell Engineering Co. Ltd.* [1963] 3 All E.R. 413, at 414, per *Lord Greene M.R.*; *Seager v. Copydex Ltd.* [1967] 2 All E.R. 415.

¹⁶⁴ Although this will have a bearing on the final proscribed remedy; *Attorney General v. Guardian Newspapers Ltd. (No. 2)* [1988], at 639 - 640, per *Lord Keith*; at 650, per *Lord Griffiths* and at 659, per *Lord Goff*.

third parties, these being prohibited from using confidential information because it is probable that they will already be aware of the circumstances surrounding the value of such information.¹⁶⁵ However, in situations where an innocent recipient overhears or stumbles across information that he uses to his benefit it is highly unlikely that liability for breach of confidence will result.¹⁶⁶

Under the present regime, governing insider dealing there is a distinct lack of an effective and accessible civil remedy.¹⁶⁷ The civil law is unlikely to be utilised by investors as a means for redress as they are either insufficiently familiar as to their rights in such situations, because they lack the necessary resources and determination with which to pursue the legal remedies available to them¹⁶⁸ or because of the difficulty caused by complex market transactions, which hinders the recuperation of pecuniary loss.¹⁶⁹ Consequently, civil actions by individual investors are not commonly regarded as an effective means of protecting the majority of investors given the expense of litigation.¹⁷⁰ However, the difficulties that stand in the way of individual civil enforcement do not necessarily affect all investors to the same extent. Implicit in the restrictions of a '*professional investor's*' right of action under the *FSA '86* is the assumption that they will be less inhibited about pursuing civil remedies

¹⁶⁵ *Malone v. Commissioner of Police (No. 2)* [1979] Ch 344, at 360. Also see generally Rider, B.A.K. (1983), *supra*, note 8, at chapter two.

¹⁶⁶ *Fracome v. Mirror Group Newspapers* [1984] 1 W.L.R. 892.

¹⁶⁷ Cohen, N. (1996), '*SFA Seeks Swifter Punishment for City Wrongdoers*', *The Financial Times*, 20/6/96.

¹⁶⁸ According to Suter, J. (1989):

“... Controversy surrounds both the principles upon which [civil] liability may be based and the formation of the remedies themselves...”

; *supra*, note 6, at 122.

¹⁶⁹ Berg, K. (1988), '*Section 62: The Full Extent of Exposure*', *International Financial Law Review*, at 29.

¹⁷⁰ Seligman, J. (1983), '*The Historical Need for a Mandatory Corporate Disclosure System*', *Journal of Corporate Law*, Vol. 9, at 56; and Gower, L.C.B. (1982), *Review of Investor Protection: A Discussion Document*, London: HMSO, at paragraph 3.41.

than their private counterparts whose right is left undisturbed.¹⁷¹ Similarly, where several investors have all suffered the same wrong at the hands of a particular firm, a class action or some other form of representative proceedings may provide an individually less daunting means of seeking redress.¹⁷²

One of the main problems faced in allowing victims of insider dealing to act and seek civil redress centres around the issue of privity.¹⁷³ Similar to criminal cases, the issue of proving that a causative *nexus* between the insider actions and victim's loss existed at the time the alleged insider dealing took place has long acted as the major stumbling block both common law and statutory actions.¹⁷⁴ Indeed, given the relative complexity created by today's market transactions it is all but impossible to prove:

*"... the moral objection is that the matching of vendor and purchaser is entirely random and there is no obvious justification for giving a vendor who happens to have sold shares to an insider a remedy which is not available to the vendors who sold similar shares at the same time at the same price to outsiders..."*¹⁷⁵

Even miscellaneous provisions¹⁷⁶ have only proven to be effective in the clearest of cases.¹⁷⁷

¹⁷¹ Section 62A FSA '86.

¹⁷² Section 61 FSA '86.

¹⁷³ Ashe, T.M. and Counsell, L. (1993), *supra*, note 1, at chapter twelve.

¹⁷⁴ Rider, B.A.K. (1988), *supra*, note 12, at 66 and MacNeil, B. (1994), 'FSA 1986: Does section 62 Provide an Effective Remedy for Breaches of Conduct of Business Rules?', *Company Lawyer*, Vol. 15, at 173.

¹⁷⁵ *Justice Report on Insider Trading*, (1972), at paragraph 34. See also *Company Law Reform* (1973), Cmnd 5391, London: HMSO, at paragraph 19 and Suter, J. (1989) *supra*, note 6, at 373; and *The Conduct of Company Directors*, Cmnd 7037, London: HMSO, at paragraph 31.

¹⁷⁶ Section 35 of the Powers of the Criminal Courts Act 1973.

¹⁷⁷ *R v. Inwood* [1975] 60 Cr. App. R., at 73 *et seq.*, per Scarman L.J..

While the United States has utilised this strategy, with some relevant success, it has not been as effective as some believe.¹⁷⁸ Indeed, although the United States has utilised novel approaches to ‘*iron out*’ many of the problems highlighted by the United Kingdom’s experience whether or not these are desirable or suitable to be imposed over here is highly suspect.¹⁷⁹ However, the United States must be commended in its approach to problematic areas. This is illustrated if one looks at section 5 of the *ITSA* where an insider is deemed to owe a duty of disclosure to contemporaneous investors¹⁸⁰ for any transaction undertaken based on inside information. It is presupposed that since the information on which the insider trades is material, any investor who would have relied upon it would have altered their conduct accordingly had the information been disclosed. Therefore, the *nexus* between the insider and the loss sustained by the investor is presumed and the loss is deemed to be sufficiently proximate. The need for privity is thus abolished. The United Kingdom may be well to take heed in learning from such approaches.

Although doubts have been cast regarding the ability of the civil law as an effective deterrent such assertions can all but be dismissed given the fact that an

178 Rakoff, J. and Eaton, E. (1996), ‘*How Effective is United States Enforcement in Deterring Insider Trading*’, *Journal of Financial Crime*, Vol. 3, No. 3, at 283.

179 ‘*Day of the Civil Sanction?*’, (1996) 17(9) *Company Lawyer*, at 257:

“... *The Treasury must appreciate that the legal environment within which civil enforcement developed in the United States are not necessarily as convincing as some academics and even the odd politician have made out. The New Zealand Parliament stumbled into civil enforcement, of a rather ineffectual kind, as a means of curtailing insider abuse. This was also on the back of a study of what was thought to happen in the United States and in particular the economic benefits! It certainly has not worked in New Zealand and in developing alternative weapons for the twenty-first century considerable thought and some imagination would not go amiss...*”

See also Cox, W. (1990), ‘*An Economic Perspective of Insider Trading Regulation and Enforcement in New Zealand*’, *Canterbury Law Review*, Vol.4, at 268 *et seq.* and Fitzsimons, R. (1995), ‘*Enforcement of Insider Trading Laws by Shareholders in New Zealand: An Analysis and Proposals for Reform*’, *Waikato Law Review*, Vol. 3, at 101 *et seq.*

180 That is, those investors that trade at the same time and on the same security as the insider; *see Shapiro v. Merrill Lynch, Pierce Fenner and Smith Inc* 495 F. 2d., at 241 [2d Cir. 1974]; *Wilson v. Comtech Telecommunications Corp.* 648 F. 2d., at 94 *et seq.* [2d Cir. 1981] and *O'Connor and Associates v. Dean Witter Reynolds Inc* 559 F. Supp., at 803 [SDNY 1983].

insider will be forced to compensate the victim¹⁸¹ thus striking at the motive of profit.¹⁸² However determining who is a credible plaintiff¹⁸³ and then placing a compensatory value on their loss¹⁸⁴ may cause subsequent problems. If one looks to the United States for guidance this may be remedied by limiting the damages payable to the profit made or loss avoided by the insider.

Given the relative success the United States has had in proving civil liability many generally assume that the type of law is far easier to prove in court than the criminal law.¹⁸⁵ However, moving to a civil standard of proof is unlikely to have the impact one would imagine. This is because for cases involving serious allegations of wrongdoing, the United Kingdom's civil standard of proof is different from that of the United States. In the United States, the case must be proved '*by a preponderance of the evidence.*' In other words, the civil prosecuting authority must demonstrate merely that it is more likely than not that the offence occurred – that there is a 51% probability of guilt. However, English courts apply a sliding scale approach to the civil standard of proof: the degree of probability required varies from case to case, and depends on the nature and gravity of the allegation. Thus, the worse the alleged conduct, the harder it is to prove.¹⁸⁶ Other differences between the two jurisdictions mean that the United States may be given a distorted view as to its effectiveness.

¹⁸¹ Anderson, A. (1982), '*Fraud, Fiduciaries and Insider Trading*', Hofstra Law Review, Vol. 10, at 371 *et seq.* and Commons Parliamentary Debates 1978/79, volume III, Standing Committee 'F', at column 1130.

¹⁸² Branson, T. (1982), '*Insider Dealing-Part III*', Journal of Business Law, at 538 *et seq.* and Posner, N. (1980), '*Optimal Sentences for White Collar Criminals*', American Criminal Law Review, Vol. 17, at 408 *et seq.*

¹⁸³ Herzal, J. and Kratz, F. (1985), '*Insider Trading: Who Loses?*', Lloyds Bank Review, Vol. 165, at 15.

¹⁸⁴ Anisman, A. (1986), *Insider Trading Legislation for Australia: An Outline of the Issues and Alternatives*, Canberra: Australian Government Publications, at 107 *et seq.*

¹⁸⁵ Naylor, J.M. (1990), '*The Use of Criminal Sanctions by U.K. and U.S. Authorities for Insider Trading: How Can the Two Systems Learn from Each Other? Part I*', (1990) Company Lawyer, Vol. 11, No. 3, at 58.

¹⁸⁶ Waters, V. and Gallinck, R. (1995), '*Insider Dealing: Time to Turn the Defence Inside Out*', *The Financial Times Magazine*, 25/11/95. Also see Payne, E. (1997), '*Chance or Recovery in Civil Actions*', Company Lawyer, Vol. 18, No. 4, at 118 *et seq.*

Such factors as the lack of a specific statutory definition as to what constitutes insider dealing means that the *SEC* is not bound by definitional parameters.¹⁸⁷ In addition, prosecutors do not have to overcome statutory defences that may be raised by the alleged insider.¹⁸⁸

If a United Kingdom regulator attempts to use a statutory imposed civil remedy it may well have to prove something approaching, or even equivalent to, the criminal standard of proof.¹⁸⁹ This is all the more perverse when one considers that, at present, most do not possess the extensive investigatory powers of criminal authorities. Consequently, it may be more difficult to prove insider dealing cases using this type of law. Indeed, some critics are of the opinion that civil actions are not quite the '*panacea some British observers believe.*'¹⁹⁰ Ireland's approach to insider dealing, being based around both criminal and civil liability illustrates its general willingness to adapt previous measures in a bid to make them more effective.¹⁹¹ Such a trait should be a desirable asset in any country. However, such ingredients in recent years have not been evident in the United Kingdom.

If the United Kingdom is to develop a new approach to insider dealing one idea may be through the adoption of new *SRO* rules, or even through the application of

187 *Ante.*

188 Alcock, A. (1994), *supra*, note 73, at 72.

189 *Bater v. Bater* [1951] 1 CA 35, *per Denning LJ*; *Blyth v. Blyth* [1966] A.C. 643, *per Denning L.J.*; *Khawaja v. Secretary of State for the Home Department* [1984] A.C. 74, *per Lord Scarman* *cf Hornal v. Neuberger Products Ltd* [1957] 1Q.B. 247.

190 Branson, T. (1982), '*American Business Law- Insider Trading - The British Regulation in the light of the American Experience*', *Journal of Business Law*, at 538.

191 McCormack, M. (1991), '*Insider Dealing- New Departures in Ireland.*' *Business Law Review*, at 146; McCormack, M. (1992), '*Insider Dealing - A New Regime for the Republic of Ireland*', *Company Lawyer*, Vol. 13, No. 5, at 108 *et seq.*; Linnane, S. (1994), '*Insider Dealing and the Irish Stock Exchange*', *Company Lawyer*, Vol. 15, No.7, at 218 *et seq.* and Ashe, T.M. and Murphy, Y. (1992), *Insider Dealing*, Dublin: Round Hall, at 114 *et seq.*. However, recently there have been calls for amendment to the 1990 Act; see Linnane, S. (1997), '*Insider Dealing in Ireland and the Pressures for Changes to the Law*', *European Financial Services Law*, Vol. 4, No. 3, at 101 *et seq.*

Authority principles.¹⁹² Such requirements would not, as some *SRO*'s rules try to do, seek to replicate the offence of insider dealing as it is defined in all its complexity at criminal law. Regulators have neither the extensive powers needed to gather neither information on offenders nor the ability to imprison them. Furthermore, regulatory interests lie in protecting investors and ensuring the integrity of financial markets, not in bringing to bear the draconian criminal powers of the state against wrongdoers. The regulators, therefore, should be able to enforce different and possibly higher standards of market behaviour than are required by the criminal law. They could decide, to adopt rules or issue guidance under the *Authority*'s principles that adapt the United States standard to United Kingdom markets by stipulating that firms or registered individuals should not trade while in possession of price-sensitive information.

In prosecuting a breach of such a rule, only those defences recognised in the rule itself would be open for debate. The multiplicity of the defences currently available under United Kingdom and United States criminal law would be irrelevant. However, the differences between United Kingdom regulators would have a tougher job than their United States counterparts because of the sliding scale civil standard of proof. Nonetheless, this approach may provide a more effective mechanism for addressing market abuse than the current insider dealing legislation. If successful, it might also serve as a basis for a standard of behaviour to be applied, through appropriate legislative change, to market participants that are not regulated by an *SRO* and thus would not be covered under this approach.

Given the new Government's past¹⁹³ and present¹⁹⁴ drive to change City regulation that it is highly probable that the form of law favoured to deal with insider

¹⁹² McVea, H. (1996), '*Fashioning a System of Civil Penalties for Insider Dealing: Sections 61 and 62 of The Financial Services Act 1986*', July, *Journal of Business Law*, at 353 *et seq.* and Graham, G. (1998), '*Private Analyst Briefing may be Banned*', *The Financial Times*, 29/6/98.

¹⁹³ Eisenhammer, J. (1995) '*Labour Pledges to Punish Insiders*', *The Independent*, 24/2/95; Donovan, P. (1995), '*Labour Plans to Rewrite the Law on Insider Dealing*', *The Guardian*, 24/2/95; Cohen, N. (1995), '*Labour to Probe Powers of City Regulators*', *The Financial Times*, 24/2/95.

¹⁹⁴ Graham, G. (1998), *supra*, note 192.

dealing will be of a civil nature.¹⁹⁵ Determining what form a specific civil remedy will take is not easy. Although it seems probable, given the political climate and the difficulty faced by investors in launching successful common law action, that any remedy developed will take a statutory form doubts as to its overall effectiveness are debatable. Moreover, its role is likely to be of a complimentary, rather than supplementary provision, as this will have the most impact. However, doubts exist whether this type of law will be any more effective than the criminal one as civil remedies are plagued with their own set of substantive and procedural problems.¹⁹⁶

195 *Trade and Industry Select Committee, Third Report on Company Investigations*, (1990), at paragraph 169; Blitz, J. (1996), 'Labour to Review Insider Dealing', *The Financial Times*, 2/5/96 and Parker, C. (1997), 'Davies Calls for New Powers', *The Financial Times*, 13/10/97.

196 *Post*, chapter five.

3.4 Summary

The purpose of this chapter was to examine the formal regulatory approaches adopted in the United Kingdom and United States in respect to insider dealing. Despite the common goal of regulation in both jurisdictions, there are important differences in their approaches can be identified. While the United Kingdom has sought to utilise concisely worded legislation the United States has used a contrasting approach. Thus, the use of loosely worded legislation has provided the foundation upon which insider trading may or may not be determined. This pervasive and, somewhat, pragmatic approach has allowed the American judiciary to supplement principles, initially derived from the *SECs*' actions and developed at common law, to create an expansive web of liability. However, they have yet to enunciate a consistent theory upon which regulation may be based. Indeed, it may be viewed as unsatisfactory to develop the law in such a piece-meal fashion, given the potentially severe sanctions a convicted person may have to endure. Moreover, it may also violate the constitutional guarantee that no person shall be penalised by an *ex post facto* law. Thus, such a position has left many market participants without any guidance as to how to arrange their conduct.

Yet, the United States has enjoyed substantial success in combating insider activities. This may be directly attributed to the persuasiveness of the *SEC* in its relentless pursuit on insider activities coupled with the widespread bargaining and the potential penalty powers it possesses.

By contrast, the United Kingdom has resorted to formal laws that are highly complex and, by comparison, rarely resorted to. Such complexity can be seen to have contributed towards the overall ineffectiveness of them that in turn has had a disastrous effect on prosecution rates. The detailed nature of the definition and the traditional tendency of the judiciary to interpret criminal statute restrictively has left little room for the courts to indulge in creative interpretation. Additionally, the exclusive reliance on criminal law has denied flexibility to the enforcement of the *CJA*. Moreover, it is ineffective to combat what is generally perceived as an essentially economic crime. *Dine* sums this position up aptly by stating:

*'... This is a clear illustration of a penal law where an attempt has been made to cater for all the complications of behaviour within the definition of a crime and control is sought to be exercised from outside the company. As a direct result of the combination of these two factors a complicated and largely unworkable law has emerged. The implementation of the EC Directive was a golden opportunity to reform the law. The opportunity has been ignored. Other solutions to the problem either penal, quasi-penal or civil have been ignored.'*¹⁹⁷

Although civil common law remedies aimed at offering forms of redress for victims of insider activities exist in the United Kingdom these are extremely hard to prove, a fact that makes them virtually redundant in providing a successful route to gain monetary compensation. The distinct lack of a civil statutory remedy has yet to materialise. Indeed, given the problems associated with causation, determining the class of potential victim and value given to any financial remuneration it looks distinctly unlikely that any legislation will be developed in the near future although legislation will be enacted. Yet the need for a civil remedy is extremely important, not only in granting what many see as a form of action more equated with this type of offence but also in a way of effectively deterring more individuals from participating in it. To this end it may be advantageous to look to other jurisdictions not too far away, such as Ireland, to learn and adapt a remedy to satisfy these aims. Indeed, it may also be advantageous if the present insider dealing legislation is re-enacted to include some of the elements of flexibility that have been so useful in determining whether insider dealing has occurred in the United States.

It is important to remove incentives for insider dealing by requiring disclosure of information but it is also necessary to prohibit dealing based on information not disclosed to the market. Disclosure alone will not suffice to eliminate insider dealing. As long as incentives exist, insiders will find ways to circumvent disclosure obligations. Disclosure also raises issues about timing and no effective way can be devised to enforce this. While the use of administrative proceedings by many SRO's

¹⁹⁷ Dine, J. (1995), *Criminal Law in the Company Context*, London: Dartmouth Publishing, at 14.

for breaches of conduct codes have provided strong incentives for members to act lawfully and fair these may be improved upon if they are strengthened. Therefore, increasing fines and actively publicising offenders as well as vigorously implementing the ultimate threat of expulsion from the market place will achieve stricter compliance with the letter of the law.

Chapter Four

Market Manipulation

Overview

Market manipulation is an extremely complicated, invariably diverse activity that embraces a multitude of trading sins. Its impact profoundly affects many types of market transaction through interfering with the fundamental market forces of supply and demand.¹ However, to equate manipulative practices with these factors alone belies the notion that certain trading activities can have some effect on the supply and demand of securities without actually being perceived as illegal in the eyes of the law. This is particularly so when the issue of stabilisation is involved,² secondary market transactions are entered into,³ especially in light of the development of electronic transactions,⁴ or when large securities transactions are carried out.⁵

It can generally be observed that the United Kingdom and United States rely on diametrically opposed ideologies concerning what constitutes manipulative

1 Andressen, A. (1942), 'Manipulation of the Over the Counter Securities', (1942) 10 George Washington Law Review, at 640; Lee, H.C. (1993(a)), 'Market Manipulation in the United States and United Kingdom: Part 1', Company Lawyer, Vol. 14, No. 5, at 84 and Mason, J. (1999), 'Trader Appeals against Manipulation Conviction', *The Financial Times*, 9/11/99.

2 *Post*, section three.

3 Rogoff, R. (1976), 'Legal Regulation of Over-the-Counter Market Manipulation: Critique and Proposal', (1976) 28 Maine Law Review, at 150.

4 'Integrity in Tomorrow's Markets', (1997) European Financial Services Law, Vol. 4, No. 11 and 12, at 282.

5 *R. v. de Berenger*, [1814] 3 M and S, at 73-74 and 105 ER, at 536, per Le Blanc J.:

"....the raising or lowering of the price of public funds is not per se a crime. A man may have occasion to sell out a large sum, which may have the effect of depressing the price of stocks, or may buy in a large sum, and thereby raise the price on a particular day, and yet he will be guilty of no offence."

behaviour. While the courts in the former country have tended to cautiously scrutinise the nature of such transactions to determine their true intentions⁶ those across the Atlantic have liberally viewed any transaction that elevates or depresses market activity to determine whether it is genuine or not.⁷

In the United Kingdom the practice of market manipulation has proven to be extremely difficult to identify due to the existence of complex commodity⁸ and derivative⁹ markets.¹⁰ Subsequently, only the most conspicuous of manipulation cases have led to detection and eventual prosecution, a fact that makes them newsworthy items.¹¹ Not surprisingly, large proportions of manipulation cases are

6 *Scott v. Brown, Doering McNab and Co.*, [1892] 2 QB 724; cf. *Sanderson and Levi v. British Western Mines and Share Corporations Ltd* [1898] 43 Sol 45 per Matthew J.:

"... No evidence had been given to show that there was anything of an illegal or fraudulent character about it..."

Additionally, see *United States v. Brown* (1933) 5 F.Supp. at 81.

7 Section 9(a)(2) SEA.

8 Murphy, D. and Saigol, A. (1997), 'The \$3 Billion Copper Caper', *The Guardian*, 15/2/97; Dawkins, P. Michiyo, I. and Gooding, C. (1996), 'Rogue Deals Cost Sumitomo \$1.8 Billion', *The Financial Times*, 14/6/96; 'The Same Old Story of Many Warnings Ignored', *The Independent*, 18/6/96; Donovan, P. (1996), 'Exchange's Future at Risk', *The Guardian*, 21/6/96; Gooding, N. and Denton, N. (1996) 'Sumitomo Copper Market Loss May Double to \$4 Billion', *The Financial Times*, 23/6/96 and Mason, J. (1997), 'Brokers to Deny Manipulation of Copper', *The Financial Times*, 28/2/97.

9 *'... The FSA ['86], which was preoccupied by investor protection issues, failed explicitly to anticipate futures transactions. As a consequence, regulation in the United Kingdom gives this a lower priority than the United States. It is not even clear that futures manipulation is illegal in London.'*

: Gilbert, W. (1996), 'Untenable Position for Manipulators', *The Financial Times*, 6/8/96.

10 Price, P. (1996), 'Skynet Relisting may be Delayed', *The Financial Times*, 3/9/96; Hughes, M. and Allen, J. (1997), 'Legal Liability in the Secondary Debt Market', *Butterworths Journal of International Business and Financial Law*, Vol. 12, No. 10, at 469 *et seq.* Holley, K. (1993), 'Market Manipulation', *Commonwealth Law Bulletin*, Vol. 19, No. 4, at 1927 *et seq.*; Hilton, S. (1994), 'Going to Extremes', *Pensions World*, Vol. 23, No. 1, at 131; Au, A. (1989), 'Stock Market Manipulation after the Financial Services Act 1986', *Journal of International Banking*, Vol. 4, No. 2, at 53 *et seq.*; 'Section 47 FSA '86: Market Manipulation', (1989) *Butterworths Journal of International Banking and Financial Law*, Vol. 4, No. 7, at 337 *et seq.* and 'A Slim CFTC', *The Financial Times*, 11/3/97.

11 The real life publicity surrounding the collapse of Barings Bank and Nick Leeson has been turned into a 'silver screen icon' with the film *Rogue Trader*, an adaptation of Leeson's book

based around take-over issues, as these offer the greatest incentives for manipulators to make substantial profitable gains. For instance, the case involving Guinness revolved around the manipulation of the share price of Distillers plc, whilst Blue Arrow was concerned with whether an illegal take up of rights had occurred in Manpower. It is generally perceived that these problems stem from the lack lustre implementation of those given the power to enforce market compliance combined with the fact that it is extremely hard, under present legislation, to prove that financial detriment has actually been caused by the manipulation itself.¹²

The purpose of this chapter is to examine such practices from the former premise, namely, that the laws utilised in this country are inappropriate for their declared purpose and that by examining the different approaches adopted in the United States some insight may be inferred in providing this country with some guidance for producing more effective ways of dealing with these practices in the future. However, a cautionary note must be issued, as the United States is still far from perfect in its pursuit of manipulative cases. This is predominantly due to the fact that:

'... manipulation claims require many years to reach trial and tremendous expense to investigate. Most CEA and CFTC manipulation cases have lasted eight years or more, and have consumed thousands of man hours of the agencies' scarce resources. Private lawsuits have had no better results. This, of course, discourages the filing of manipulation cases and virtually eliminates their deterrent effect.'¹³

with the same title, now on release. Indeed, Hollywood 'gloss' has been applied to manipulative practices before with the production of the film *The Hudsucker Proxy* (1994) and Oliver Stone's 'greed is good' venture, *Wall Street* in the mid-1980's which centred on insider trading.

12 In 'Poll Position', *The Observer*, 10/4/97, 99% of people questioned said market manipulation would continue undaunted.

13 Markham, K. (1987), *Commodities, Regulation, Fraud, Manipulation and Other Claims*, at paragraph 15.02 et seq..

*This chapter is divided into three parts. Part one provides a historical basis as to how manipulative practices have evolved and how this impact affects the markets today. Part two examines the current types of manipulative practices used on today's securities markets. Lastly, part three provides a comparative analysis between the United Kingdom's, and United States' various approaches to this type of market abuse.*¹⁴

¹⁴ Although market manipulation is not strictly a fraudulent practice since it does not employ an element of non disclosure the manipulative act itself is tantamount to fraud; Wolfson, L. (1972-73), 'Rule 10b-6 and the Illusory Search for Certainty', Stanford Law Review, Vol. 25, at 95 *et seq.*

4.1. Market Manipulation - A Historical Perspective

Historically, manipulative practices are not a new phenomenon with many references being made of these practices permeating trading markets. *Homer*, for instance, was known to have referred to such fraudsters as '*tricksters dealing in countless and worthless trinkets to the scandal of the market*'.¹⁵ Furthermore, evidence exists of frauds revolving around the manipulation of common commodities in the fourteenth century¹⁶ and precious metals during the sixteenth century.¹⁷ During the seventeenth century these practices ravaged the markets of London so much so that a Royal Commission was established.¹⁸ It reported that:

"... The pernicious Art of Stock-jobbing hath, of late... wholly perverted the End and Design of Companies and Corporations, erected for the introducing, or carrying on of Manufactures,... by selling their shares for much more than they are really worth.. Thus, the Management of that

15 Redfield, J.M. (1986), *The Development of the Market in Archaic Greece*, in Anderson, B.L. and Latham, A.J.H. (eds.), *The Market in History*, London: Croom Helm, at 52 *et seq.* and Mitnick, B.M. (1980), *The Political Economy of Regulation*, New York: Columbia University Press, at 243 *et seq.*

16 See generally *Russel on Crime*, (12th ed.), at Chapter 100; Jones, E. (1925-26), '*Historical Development of the Law of Business Competition*', *Yale Law Journal*, Vol. 35, at 906-7; Mason, H. (1937-38), '*Monopoly in Law and Economics*', *Yale Law Journal*, Vol. 47, at 38; *Statute of the Realm*, (1363), 37 Edw. IIIc. 8. With regard to the practice of engrossing; see, in addition, *Mogul Steamship Co Ltd v. McGregor, Gow and Co et al.*, [1889] 23 QBD 598.

17 See generally O'Keefe, J. (1966), *Law of Weight and Measures*, London: Butterworths.

18 It was observed at the time that financial markets operated on a trade founded in:

"... fraud, born of deceit and nourished by trick, wheedle, forgeries, falsehoods, and all sorts of delusions..."

; Defoe, D. (1697), *The Anatomy of Change Alley: A System of Stock-jobbing*, in Rider, B.A.K., Abrams, C. and Ferran, E. (1992), *Guide to the Financial Services Act 1986*, Bicester:CCI, at paragraph 104. In addition, see Mathias, R. (1936), '*Manipulative Practices and the Securities Exchange Act*', *University of Pittsburgh Law Review*, Vol. 3, at 107 where it was observed that manipulative '*pools*' were used on European exchanges during this period.

*Trade and Stock comes to fall into unskilful Hands, whereby the Manufactures... dwindle away to nothing.”*¹⁹

Yet despite Parliament enacting *the Act to Restrain the Number and Practice of Brokers and Stock-Jobbers* market manipulation remained persistently widespread, with circulars produced urging Parliament to fortify the regulatory measures taken against stock-jobbers:

*“... Stock Jobbing hath been so Pernicious to Trade in general, and Ruinous to many Families in particular, its therefore very necessary that a more effectual Law, than the late Brokers Act should be made against that pernicious Practice.”*²⁰

With the advent of war the medium of falsely placed rumours was commonly used to manipulate share prices.²¹ This was judicially recognised in a number of prominent cases,²² although the most famous one is probably that of *R v. de Berenger*.²³ In this case a number of defendants manipulated stock prices by circulating false rumours²⁴ about the death of Napoleon and that the allies had entered Paris.²⁵ Cases like this illustrated the dilemma faced by the courts in penalising such

¹⁹ *House of Commons Journals*, 25th November 1696.

²⁰ *Reasons on Behalf of Many Eminent Merchants for Continuing the Late Brokers Act under Further Regulations*; Anon (1700).

²¹ Mortimer, T. (1791), *Every Man His Own Broker*, London, at 53 *et seq.*

²² *Gillett v. Peppercorne* [1840] 3 Beav 78 and *Barry v. Croskey* [1861] 2 John and H 1.

²³ [1814] 3 M and S 66 and 105 ER 536.

²⁴ Rumours still form a large part of manipulative techniques used today although they are usually combined with other forms of manipulation, such as pools; Branda, G. (1951), ‘*Manipulation of the Stock Markets under the Securities Laws*’, *University of Pennsylvania Law Review*, Vol. 99, at 661 *et seq.*

²⁵ For commentary on *de Berenger* and other general aspects of manipulation; see Ashe, T.M. and Counsell, L. (1993), *Insider Trading*, London: Fourmat Publishing, at 9 *et seq.*

behaviour.²⁶ Yet, the courts tended to air on the side of caution, unwilling to issue harsh sentences, a view that one could say still prevails today.²⁷ It can be argued that the underlying reasoning behind this relates to a general reluctance on the part of the judiciary to interfere with the established practices and principles laid down by the City itself.²⁸ However, manipulative practices were not geographically confined to the United Kingdom for the markets of the United States had also long been subject to such elusive practices, it being estimated that at the turn of this century one third of all securities trading represented on the New York Stock Exchange were of a manipulative nature.²⁹ Similarly, in Australia the *Rae Report* detailed many of the market rigging practices prevalent in that country during the 1960's.³⁰ In other common law jurisdictions such as Canada³¹ and Hong Kong, legislation³² also exists that seeks to curtail these types of market abuse. With regards to the latter

26 Contradictory judicial attitudes towards market manipulation are evident if one reviews the judgements in the cases at this time. On one hand the judiciary recognised the value that should be placed on the concept of a 'free and open market'; see *de Berenger, supra*, note 5, at 538, *per Lord Ellenborough C.J.*:

"... (If)...the purpose itself is mischievous, it strikes at the price of a vendible commodity in the market, and if it gives a fictitious price, by means of false rumours, it is a fraud levelled against all the public..."

, a view also affirmed in *R v. Aspinall* [1876] 2 QB 48. However, it was also recognised that market manipulation was common practice; see *Scott v. Brown, Doering McNab and Co.*, [1892] 2 QB 729 *et seq.* and Welby, J. (1992), 'Do Business Ethics Matter', *International Company and Commercial Law Review*, Vol. 3, No. 2, at 45 *et seq.*, where it is argued that manipulative practices are favourable in that they allow manipulator's to utilise their full potential as market operators *cf.* entrepreneurial aspects of insider dealing, *ante.*, chapter two, section 2.

27 Rider, B.A.K. (1994), 'A Fair Cop', *Company Lawyer*, Vol. 15, at 2 and Widlake, B. (1995), *Serious Fraud Office*, Warner Books: London, at 72 *et seq.*

28 *Post*, chapter one and *ante.*, chapter six.

29 Loss, L. (1995), *Securities Regulation*, Little, Brown and Company: Boston, at Chapter 10.

30 See generally the *Australian Securities Markets and Their Regulation Part 1: Report from the Senate Committee*, at chapter eight.

31 *Section 325 Canadian Criminal Code*. Interestingly, the SEC has actively sought to impose its rules on foreign markets including Canada; see Jacobs, B. (1989), 'US-Canadian Offerings: the SEC's View on Market Manipulation', *International Financial Law Review*, Vol. 8, No 12, at 8 *et seq.*

32 *Part XII Securities Ordinance*.

jurisdiction, the control of securities fraud and market manipulation is dealt with in *part XII of the Securities Ordinance*. Section 135 of the *Ordinance* frowns upon every artificial device used to persuade the public that the activity of a security is a reflection of genuine supply and demand where it is not in fact so.³³ Section 136 of the *Ordinance* is a general anti-fraud provision in terms of which an offence can be committed notwithstanding that the fraud has not been acted on.³⁴ Provision is made for criminal offences in section 139 and civil remedies in section 141 of the *Ordinance*. The *Ordinance* is based on two separate but inter-related principles, namely the anti-fraud principle and the open market concept.³⁵ The enforcement of stock-market manipulation poses a problem in Hong Kong as the *Ordinance's* exclusive reliance on criminal sanctions as a means of proscribing manipulation and protecting investors gives little cause for optimism. The Hong Kong law with regard to civil remedy is unclear and it has also been observed that a victim of manipulation has to overcome various hurdles including proving that he brought or sold the securities at a price which was affected by manipulative activity.³⁶

Other jurisdictions such as South Africa and Spain also have made deliberate attempts to broaden the scope of market manipulative provisions and establish more effective methods of sanctioning. Such provisions have been brought into force due to the ideological belief that markets should be free flowing governed only by the natural interaction of supply and demand.

33 Au, A. (1988), '*Regulating Securities Fraud and Market Manipulation in Hong Kong: Part XII of the Securities Ordinance*', Hong Kong Law Journal, Vol. 18, at 28 *et seq.*

34 Section 136 can be divided into three parts: false and misleading appearance of active trading, wash sales and the dissemination of information relating to market-rigging operations.

35 Au, A. (1988), *supra*, note 33, at 26:

'It is in the interest of the community that the market for securities should be real and genuine, free from manipulation. Stock market manipulation should be outlawed because it amounts to tampering with the natural equilibrium of market forces.'

36 Au, A. (1988), *op. cit.*, at 47 *et seq.*

With regards the former jurisdiction, manipulative practices are prohibited by virtue of section 40 of the *Stock Exchange Control Act 1985* and sections 20 to 22 of the *Financial Markets Control Act 1989* which prohibit false trading and market manipulation in futures and options. Section 23 of the *Financial Markets Control Act* makes provision for an action for damages in terms of which a person who contravenes the prohibition on false trading and market manipulation shall be liable to pay any damages to any other person who suffered a loss on account thereof.³⁷

In Spain market manipulation is covered under article 99.i of the *1988 Securities Market Law*. This forbids practices intended to distort the free formation of prices on the securities market. This is a provision of broad application and covers most forms of manipulation, including deliberate price movements or misleading statements or transactions. Any breach of article 99.i is enforced by the *CNMV* (the Spanish securities regulator) with any penalties made being imposed by the Minister of the Economy. Such penalties can include: one to five times the profit made under any breach; up to 5% of the perpetrator's financial resources; up to 5% of the money used to perpetrate the breach; or up to 50 million pesetas.³⁸

While today's markets still bare the scars of manipulative scams³⁹ fewer incidences of securities manipulation are actually detected when compared to the past. Yet the underlying reasoning for this seems to lie not with the fact that fewer are actually being perpetrated but that with advancement of technologically initial detection and further investigation are effectively clouded.⁴⁰ Thus, it can be

37 Van Zyl, F. (1994), '*Regulation of International Securities Fraud*', *Twelfth International Symposium on Economic Crime*.

38 *Financial Services Authority, Market Abuse – Part 1: Consultation on a Draft Code of Market Conduct*, (June) (1998), at 44.

39 Interestingly, this area has pricked the interest of the public so much that a spawn of semi-readable accounts of manipulative frauds that occurred in the 1980's and 90's have been published; see, for example, Stewart, J. (1991), *Den of Thieves*, Simon and Shuster: New York; Stevens, M. (1987), *The Insiders*, Putnam: New York and Levine, D. (1991), *Inside Out: An Insider's Account of Wall Street*, Putnam: New York.

40 *Post*, chapter one.

presumed that as so manipulative practices cascade they will evolve into new and more elusive forms. Indeed, given that section 47(2) *FSA '86* is so broadly worded with an inadequate number of precedents to support it, offering valuable guidance for lawyers and judiciary alike, it looks likely that this position will not get any better under the present regime.⁴¹ The inadequacy of the resources presently utilised in this country will also exacerbate this situation, especially when such practices take place on secondary markets that, in recent years, have provided a steadfast foundation upon which new issue markets are based.⁴²

41 In the last decade only two main cases have been brought in the United Kingdom regarding manipulative market practices. These relate to the cases of *Guinness* and *Blue Arrow*, see *infra*.

42 Hilton, A. (1994), '*All Change*', *Pensions World*, Vol. 23, No. 5, at 171 and '*Fine Imposed on KB Subsidiary*', (1995) *Financial Services Law Letter*, Vol. 8, No. 5, at 3 *et seq.*.

4.2. *Varieties of Manipulative Conduct and Deceptive Practices*

4.2.1. *Differing Concepts of Manipulative Practices*

Manipulative devices are used to either control or alter the natural progression of securities market values.⁴³ It is not surprising, therefore, that these practices are seen to conflict with the legal reasoning of both the United Kingdom and United States, that financial markets should operate in an open manner free from fraudulent activity.⁴⁴

There are many different types of trading that come under the generic term of market manipulation.⁴⁵ Such activities are usually described in relation to the unique attributes they possess in making a profit for those that operate them.

Wash sales, for instance, are used to create the facade that securities are being actively traded upon, although unbeknown to those who trade upon them there is no change in beneficial ownership since the manipulator induces others to buy by purchasing and selling the securities either simultaneously or within a short period of time. This is usually achieved by the placing of an order to sell with one broker while simultaneously placing another order with the same or different broker to purchase the exact same number of shares back. To be as effective as possible in achieving a wash sale manipulators must deal in a variety of securities at one given time. Additionally, perpetrators of wash sales will often use false accounts to conceal the true ownership of the manipulated securities.

43 *Ernst and Ernst v. Hochfelder* [1976] 425 US 199.

44 Loss, L. (1995), *supra*, note 29, at 930-934 and *United States v. Brown*, *supra*, note 6, at 85, *per Judge Woolsey*:

“... He (the outsider) is justified in supporting that the quoted price is an appraisal of the value of that stock due to a series of actual sales between various persons dealing at arm's length in a free and open market on the exchange...”

45 Rider, B.A.K. *et al.* (1992) *supra*, note 18, at 128.

Another type of manipulative practice is the use of matched orders. These come into existence when an individual enters a transaction for the purchase or sale of a security with the knowledge that an associate at will enter a matching transaction substantially the same time, price and/or size.⁴⁶ In such instances, both parties usually conceal their identities from the market by dealing through a third party, usually an unsuspecting broker.

Pools are yet another common form of manipulative conduct. They are usually created by groups of people combining to rig the market.⁴⁷ Their sole objective is to either stimulate or depress market activity in a security so to generate a profitable income for all those who are pool members. Pools can be either '*bull*' or '*bear*' in nature. The former operates to raise the price of a security to make a profit for the pool. This is achieved by pool members initially acquiring options on the security. During this stage the pool will depress the price of the security by masterminding heavy sales, although purchases by the pool will outnumber its sales since its operations will still be in the accumulation stage. Once it has found a significant position in the particular security, the pool will attempt to cause an appreciation in the value of the particular security. The pool may then resort to trading although this may also be followed by rumours and false publicity about the prospects of the stock that consequently causes a rise in the price of the security. Such a distribution of the false information may be orchestrated through the medium of the press by carefully placing tips with or without the collusion of brokers. If the pool is successful in driving up the price of the security, then the stock will be unloaded onto the market. Its members will call the options and sell the converted stock at a profit. It is usually unwise for pools to sell all their stock at once since heavy selling is likely to depress the price of the stock. Therefore, the pool will continue to stabilise the market by purchases, although sales will outnumber this.

46 In the United States this issue has been narrowly construed; see *Wright v. SEC* [1943] F 2d 733.

47 Branda, G. (1951), '*Manipulation of Stock Markets under the Securities Laws*', University of Pennsylvania Law Review, Vol. 99, at 661 *et seq.* and '*Market Manipulation and the Securities Exchange Act*', (1937) Yale Law Journal, Vol. 46, at 512 *et seq.*

'*Bear pools*' are frequently used by manipulators to find securities at a price lower than on the prevailing market.⁴⁸ They seek to depress the price of a security by artificial means. Therefore, rather than accumulating securities, pool members will sell securities short and ultimately buy them at depressed prices to cover their position. During the initial stage sales by the pool will exceed its purchases. In its second phase, the activities of the pool will be aimed at marking down the price by the various mechanisms referred to above. Once the prices are sufficiently lowered, the pool's purchases begin.

The use of corners and short sales techniques are also common. The former occurs when a group of traders ultimately control the supply of an investment requiring investors holding short positions to settle their obligations at artificial prices. However, for cornering to have a desired effect, the issued capital of the particular company involved must be small and there must be few short sellers.⁴⁹ Short sales involve an investor selling securities that, at the time of the sale, he does not own.⁵⁰ If the broker through whom the investor places the order were to execute the order, the investor will be short in the particular stock. The short seller would effect the sale in anticipation of a fall in the price of the security and his aim would be to make a profit by buying at a lower price the same number of shares. Normally the broker would borrow the shares, as the purchaser will require delivery of those shares. He could do so from another broker. The broker need not actually borrow the shares until he is required to execute the transaction that would normally be five business days later.

48 *Delafield and Delafield* [1967-69] CCH FSLR, at 648, Exchange Rel. No. 8480 (26/12/68).

49 Tan, *Securities Regulation in Singapore and Malaysia*, (1978), at 434 *et seq.*. Cornering can be traced back to the seventeenth century when local cornering of imported commodities was common place. Indeed, one writer complained that in this time '*these monopolists began to swarm like the frogs of Egypt.*'; Hearnshaw, E. (1908), *Leet Jurisdiction*, London, at 114.

50 Hart, E. (1979), '*The Regulation of Stock Market Manipulation*', Australian Business Law Review, Vol. 7, at 143 *et seq.*. See also *Short Selling in the Stock Market*, House Reports, (1992) 102-414, Federal Securities Law Reports and Macey *et al.* (1989), '*Restrictions on Short Sales: An Analysis of the Uptick Rule and its Role in View of the October 1987 Stock Market Crash*', Cornell Law Review, Vol. 74, at 799.

An underwriter can additionally make an issue ‘*hot*’ manipulating the demand for the stock.⁵¹ This may be affected by distributing misrepresentations regarding the stock or purchasing the stock himself to give an appearance of market activity in the stock. Prices in a hot issue may be manipulated in various other ways⁵² such as:

- (i) by deliberately fixing a low initial offering price;
- (ii) by delaying to notify allottees of their allotment;
- (iii) failing to deliver stock certificates to allottees to prevent them from disposing of them;
- (iv) by allotting securities to firms trading in the over the counter market to induce them to actively make a market in the issue; or
- (v) by simply discouraging customers from selling the securities on pain of being excluded from future deals.

Warehousing practices, too, manipulate securities by allowing broker-dealers, if they agree to benefit themselves and insiders of the company, to limit the floatation of particular securities. Thus, if it can be surmised that particular securities to be traded upon will reach a premium rate soon after official launch an informal agreement will be made between the manipulator and their associates so that some will be withheld from the public in the expectation of selling them at a premium once the desired rate has been reached. Although such a premium rate may occur naturally the use of warehousing may mimic this by artificial means providing financial benefit for its instigators. Not unlike wash sales, beneficial ownership of the securities is hidden by a sham transaction in an account of a third party. One way of successfully controlling the supply of securities is to make a play for them at the distribution stage.

51 Hazen, N. (1996), *Securities Regulation*, New York: Little, Brown and Co., at 312 *et seq.*

52 Rotberg, P. (1962), ‘*The Hot Issue*’, *Business Lawyer*, Vol. 17, at 360.

This is usually achieved by parking or warehousing the shares. The underwriter, therefore, may allot stocks only to purchasers who do not intend or who undertake not to dispose of them for some time. The underwriter may also allocate a good portion of the issue to accounts over which he has influence or control, such as discretionary accounts. Additionally, he can issue stocks to favoured accounts, such as those belonging to his affiliates.

Parking refers to the sale of securities on the understanding that they will be repurchased by the seller later. The true ownership of the stock is concealed. The economic risk of the bargain would remain with the seller. Parking may be distinguished from warehousing, which term refers to the purchase of securities by one party for or on behalf of another party. For example, a broker may purchase stock in a target on the instructions of the bidder and under an arrangement by which the broker agrees to transfer the stock to the bidder once bid is announced. The difference between parking and warehousing is that parking is achieved through a sham transaction. However, parking does not always constitute a manipulation, in the sense of creating an artificial market, as it may be effected for various other reasons, such as the avoidance of reporting requirements, net capital and margin rules. Nevertheless, parking may be adopted as part of a larger scheme to manipulate the market. For instance, parking was effected by the defendants in the *Blue Arrow*⁵³ case to mislead the market and to conceal the fact that the rights issue of *Blue Arrow* was unsuccessful. Parking can be effected by an underwriter as part of a manipulative scheme to artificially restrict the supply of stock to avoid depressing the market. This may occur in a new issue that is the subject of speculative activity. The stock will be issued at one price and soon bid up to a much higher price once trading has commenced. Underwriters or dealers can feed speculative activity by parking stock in bogus or nominee accounts as part of the initial distribution and then sell them into the secondary market at higher prices.

53 See generally DTI Inspectors' Report, *County Natwest and County Natwest Securities*, (1989), London: HMSO.

Runs are yet another form of manipulative conduct. They generally involve a group of people creating activity in a security by their own concentrated buying and simultaneously distributing rumours, true or false, to cause a sharp increase in the price of the shares. Once the price of shares appreciates, those responsible for causing the market activity will unload their holdings at a profit.⁵⁴

With the combination of rapid growth, the participation of inexperienced investors and the lack of effective regulation all of the aforementioned types of manipulative conduct, which are directly centred around securities markets, are bound to grow. However, there are other types of manipulative conduct that exist which are so directly linked to such market activities and these will be considered now.

Boiler room operations are yet another form of deceptive practice that involve high pressure sales of commodities where the majority, if not all, investor's money is stolen. Investors fall prey to unscrupulous con-men who falsely claim to operate legitimate commodity trading firms. High commissions and misrepresentations ensure that little, if any, of the clients money will be invested in commodity futures.

It is more difficult for an investor to detect at an early stage that he has been cheated in a commodity fraud than in a securities scam. In a boiler room operation involving the sale of shares, the victim will discover his loss soon after the shares are not delivered to him, whereas in a commodity fraud the victim will not be suspicious until after the time of delivery has passed – usually six months to a year after the sale. Delivery may also be intentionally delayed until the company has had an opportunity to accumulate numerous '*clients*'.

⁵⁴ Hart, E. (1979), *supra*, note 50, at 145.

4.3. *The Differing Legal Approaches to Market Manipulation*

4.3.1. *The American Position*

Since 1929 Congress has actively sought to prevent manipulative practices from infesting the market place as they originally did.⁵⁵ The enactment of section 1756 of the *SA* and more specifically sections 9, 10, 13, 15⁵⁷ and 21 of the *SEA* can lead to the assertion that the American government has long recognised the problems associated with such practices and has taken the initiative to act upon it.

However, in recent years there has been a focus of concern on the effect institutional investors, such as mutual and pension funds or insurance companies have had in creating undesirable fluctuations and distortions in the market price of certain securities. These problems have been compounded by an increased blurring between the distinction of what can be perceived as manipulative or legitimate practice;⁵⁸ a problem that has also affected the United Kingdom.⁵⁹ This problem is particularly evident where securities dealers and others participating in a public offering or distribution of securities simultaneously bid for or purchase the same security or where corporations influence the price of their own shares by purchasing them in the open market. In such instances, the American courts have tended to adopt a flexible

55 See generally the *Stock Exchange Practices, Hearings before the Committee on Banking and Currency, U.S. Senate, 73rd Congress, 1st Session.*

56 Section 17(a) comes into effect when manipulative practices are seen to occur on the *Over-the-Counter (OTC)* market. Section 10b *SEA* additionally has this effect.

57 This section and in particular section 15(c) and rule 15c1-2 promulgated thereupon only relate to brokers and dealers trading in securities other than those on national exchanges. Therefore, if a broker-dealer engages in manipulative conduct on *OTC* markets he will attract liability under such laws if convicted. Because the language used in rule 15c1-2 is virtually the same as rule 10b-5 the same elements of proof will be needed to gain a conviction.

58 *US v. Mulheren* [1991] US App Lexis 14392 [CA2, 1991] Doc No 90-1691.

59 Rogoff, R. (1976), *supra*, note 3, at 152 and *post*, section 3.1.1..

approach of enquiring into the very nature of the transaction.⁶⁰ Therefore, such factors as the volume, the trading by multiple brokers or the timing of the transaction will be taken into consideration in determining whether those involved committed an illegal or legal act.⁶¹

Yet, the courts have shifted away from enforcement against those who have controlled or dominated market activity,⁶² it being argued that the *SEA* was not intended to impose liability on block or bulk orders even if they affected the market value of a security.⁶³ Therefore, it can be surmised that the attraction of any liability under the *SEA* will only come into effect when such block orders are combined with other events, such as *scienter* (i.e. the intention to defraud) which will transform them from being acceptable and perfectly legal practice to being manipulative and therefore illegal. Such events also play a major role in determining whether a defendant attracts liability under section 47(2) *FSA '86* in the United Kingdom.⁶⁴

Section 9(a)1 *SEA* essentially details those activities that can be identified as wash sales and matched orders. The section thus makes it illegal for any person to engage in certain types of conduct for the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security. If an individual or individuals either effect any transaction whereby there is no change in the beneficial ownership or enter into a sale or purchase of securities

60 The adoption of such a flexible approach by the United Kingdom's judiciary, it will be argued *post*, is highly unlikely given the restraints imposed by the lack of case law in this area coupled with the doctrine of judicial precedent.

61 'The Regulation of Manipulation by SEC Rule 10b-5', (1973) New York Law Forum, Vol. 18, at 513.

62 Branda, G. (1951), *supra*, note 47, at 663.

63 Lowenfels and Bromberg, 'Security Market Manipulations: An Examination and Analysis of Domination and Control, Front running and Parking', (1991) Albany Law Review, Vol. 55, at 309.

64 Lee, H.C. (1993(b)), 'Market Manipulation in the US and UK: Part 2', Company Lawyer, Vol. 14, No. 7, at 124.

with the knowledge that an order of substantially the same size, at substantially the same time and at substantially the same price, for the sale or purchase of any such securities, has been or will be entered by or for the same or different parties this will be deemed unlawful under this section.

While some broker-dealer practices will be ensnared under this section of the *SEA* they may not be manipulative *per se*. Such an assumption will only be made if a fraudulent intent can be inferred from either the defendant's actions or from clear evidence connecting the defendant with the alleged manipulative activities.⁶⁵ Although there are very few defences that can be used to justify those offences committed under section 9 *SEA* the use of customary practices is deemed as the one most accepted. Thus, if an individual or firm can prove that they were acting on the instructions of another they will be deemed by the courts to be not committing an offence under section 9 *SEA*, since the beneficial ownership in the securities will have moved from one side to the other. However, if discretionary or company accounts have been used by the same individual or firm who initiated such a transaction, then it will be assumed that some manipulative practice has come about.

Section 9(a)2 *SEA* covers those transactions which amount to manipulative pools where a number of individuals participate in either creating a bull or bear effect on the securities market. It is, therefore, unlawful for any person to effect a series of transactions in any security,⁶⁶ creating actual or apparent active,⁶⁷ or raising or depressing the price, for the purpose of inducing the purchase or sale of such security by others.⁶⁸ Section 9 *SEA* also ensnares a wide variety of other manipulative practices. These can be seen to include the circulation or dissemination of false

65 *Harold White and Francis Weld* [1938] 3 SEC 466, 510.

66 It has been suggested that the number of transactions entered into need only be as few as three to attract liability; Lee, H.C. (1993(a)), *supra*, note 1, at 85.

67 Either one of these criteria has been held sufficient to bring this section into effect; see *U.S. v. Stein* [1977] 456 F.2d, at 850 (2nd Cir.)

68 By contrast, the *FSA '86* adopts a more capacious view of the nature of inducement. Thus, it relates to inducing another person to 'acquire, dispose, subscribe for or underwrite' the investment(s).

information,⁶⁹ or the making of a false or misleading statement relating to the price of a particular security.⁷⁰ No special relationship between the parties concerned need be proven as the courts have deemed it sufficient for evidence of knowledge of the scheme to attract liability.⁷¹

Section 10(b) *SEA* is a catch-all provision, designed to deal with those abuses that have escaped the specific prohibitions of sections 9 and 10(a).⁷² This section makes it unlawful for any person to use the mails or facilities of interstate commerce so as to use or employ, in connection with the purchase or sale of any security any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the *SEC* may prescribe as necessary or appropriate in the public interest of for the protection of investors. It is interesting to note that section 10(b) does not by its terms make anything unlawful unless the *SEC* has adopted a rule prohibiting it.

Under this section rule 10b-5 has been promulgated. The rule itself is viewed as being one of the fundamental cornerstones of all the anti-fraud provisions utilised in the United States⁷³ and is defined as follows:

‘It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

⁶⁹ Section 9(2)4 *SEA*.

⁷⁰ Section 9(2)6 *SEA*.

⁷¹ *Russell Maguire and Co* [1941] 10 SEC 322, 341.

⁷² *Santa Fe Industries Inc. v. Green* [1977] 430 US 462.

⁷³ Hazen, N. (1996), *The Law of Securities Regulation*, at 702 *et seq.*

- (2) *to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of circumstances under which they were made, not misleading, or*
- (3) *to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.'*

In the past 60 or so years since its adoption, this simple rule has been invoked in countless *SEC* and private proceedings, and applied to almost every conceivable kind of situation. It has spawned a formidable outpouring of legal scholarship, including a number of leading books⁷⁴ and innumerable law review articles.⁷⁵

In the 1970's and 80's, many federal appellate courts and district courts developed expansive interpretations of rule 10b-5 (along with other anti-fraud provisions). They applied it to impose liability for negligent as well as deliberate misrepresentations, for breaches of fiduciary duties by corporate management and for failure by directors, underwriters, accountants and lawyers to prevent the wrongdoing by others. In private actions for damages, the courts were willing to imply a private right of action in anyone whose losses were even remotely connected with the alleged wrongdoing, or even in someone who had suffered no loss if his suit would help to encourage compliance with the law. The Supreme Court aided and abetted this

74 Lee, H.C. (1993(b)), '*Market Manipulation in the US and UK: Part 2*', *Company Lawyer*, Vol. 14, No. 7, at 124.

75 Bearle, B. (1931), '*Liability for Stock Market Manipulation*', *Columbia Law Review*, Vol. 31, at 264; Moore, B. and Weisman, E. (1934) '*Market Manipulation and the Exchange Act*', *University of Chicago Law Review*, Vol. 2, at 46; Mathias, J. (1936), '*Manipulative Practices and the Securities Exchange Act*', *University of Pittsburgh Law Review*, Vol. 3, at 7; '*Market Manipulation and the Stock Exchange Act*', (1937), *Yale Law Journal*, Vol. 46, at 624; Bearle, B. (1938), '*Stock Market Manipulation*', *Columbia Law Review*, Vol. 38, at 393; '*Regulation of Stock Market Manipulation*', (1947), *Yale Law Journal*, Vol. 56, at 509; Branda, G. (1951), '*Manipulation of Stock Markets under the Securities Laws*', *University of Pennsylvania Law Review*, Vol. 99, at 651; Jacobs, L. (1973), '*Regulation of Manipulation by SEC Rule 10b-5*', *New York Law Forum*, Vol. 18, at 511 and Posner, N. (1986), '*Stock Market Manipulation and Corporate Control Transactions*', *University of Miami Law Review*, Vol. 40, at 671.

development, giving an expansive reading to the terms ‘fraud’ and ‘purchase or sale’ and to the ‘connection’ that had to be found between them.

However, in 1975, a new conservative majority on the Supreme Court sharply reversed this trend and in a series of decisions gave a narrow reading to the terms of rule 10b-5 and other anti-fraud provisions, thus limiting the situations in which a private right of action could be implied. The tone of these Supreme Court decisions was classed as even more important than their actual holdings as they cast doubt on the validity of many of the expansive decisions of preceding years, including those that have not been specifically overruled.

Although not arranged in any logical order there are three separate clauses in rule 10b-5. Clause (1) and (3) speak in terms of ‘*fraud*’ or ‘*deceit*’ while clause (2) speaks in terms of misstatements or omissions. It is generally assumed, however, that clause (3), which prohibits ‘any act, practice or course of business which operates or would operate as (a) a fraud or deceit (b) upon any person (c) in connection with.... the purchase or sale of any security,’ has the broadest scope. Each of the elements of this formulation has given rise to interpretative questions.

It has now become established under the rulings of the Supreme Court that no person can be found to have violated rule 10b-5, in either a *SEC* or private action, unless he is shown to have acted with *scienter*. This was firmly established that in the case of *Ernst and Ernst v. Hochfelder* where the American Supreme Court stated that manipulation indicated:

“... *intentional and wilful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities...*”⁷⁶

The *scienter* requirement, in the view of some courts, does not require that the person acted intentionally or wilfully,⁷⁷ but may be met by showing that he acted

76 [1976] 425 US 185. In addition, see *Aaron v. SEC* [1980] 446 US 680.

recklessly.⁷⁸ However, the courts have adopted a flexible approach in their attempts to find a *scienter*. Thus, where the manipulator has avoided a loss or made a gain through his activities the courts have readily acted against them,⁷⁹ although it has been noted that this does have limitations. Interestingly, the Supreme Court has held that a violation of clause (2) or (3) of section 17(a) *SA* (from which the language of the corresponding clauses of rule 10b-5 was adapted) can be established without showing *scienter*.⁸⁰ Thus, the language of clause (2) and (3) of rule 10b-5, because it is based on section 10(b) *SEA*, has a different meaning than the corresponding language in section 17(a) *SA*.

Since the *SEC*'s rule-making power under section 10(b) is to be *exercised 'for the protection of investors,'* it can be argued that the only persons entitled to the protection of rule 10b-5 are those who can be classified as '*investors*.' However, the definition has been stretched in a number of ways. One of the most important came in *Hooper v. Mountain States Securities Corp.*⁸¹ involving a suit by a corporation which had been defrauded into issuing shares for an inadequate consideration. The defendant argued that the issuance of stock was not a '*sale*' and that the corporation was not an '*investor*.' The court rejected both arguments, holding that the issuance was a '*sale*' and that the corporation, having parted with shares which had economic value, was in the same position as an investor.

While the fraud must be '*in connection with the purchase or sale,*' it need not relate to the terms of the transaction. Thus, in *Superintendent of Insurance v. Bankers*

77 Although it can be noted that the courts have sometimes adopted a broader interpretation of the *scienter* in order to convict a defendant; see *Cargill Inc. v. Hardin* [1971] 452 F.2d 1154 where it was held that intentional conduct amounted to manipulation. In addition, some courts have embraced a '*fraud on the market theory*' so to allow an action to be brought against a defendant without proof of reliance by the plaintiff; see *Blackie v. Barrack* [1975] 524 F.2d 891, *Panzirer v. Wolf* [1981] 663 F.2d 365 and *Shores v. Sklar* [1981] 647 F.2d 462.

78 *Sanders v. John Nuveen* [1977] 554 F.2d 790.

79 *US v. Charnay* [1976] 537 F.2d 341.

80 Lee, H.C. (1993(a)), *supra*, note 1, at 86.

81 [1960] 282 F.2d 195.

Life and Casualty Co.,⁸² a group which obtained control of an insurance company caused it to sell certain securities which it owned, then misappropriated the proceeds for their own benefit. The Supreme Court, reversing the courts of appeals, held unanimously that

“... since there was a ‘sale’ of a security and since fraud was used ‘in connection with’ it, there is redress under section 10(b), whatever might be available as a remedy under state law...”

However, subsequent lower court decisions have read this decision narrowly, holding that the fraud must have infected the securities transactions itself, rather than merely involving a misappropriation of the proceeds,⁸³ and that there is no liability when there is a substantial time gap or no direct causal link between the sale and the alleged fraud.⁸⁴

The most important extension of the ‘*in connection with*’ language came in the decision reached in *SEC v. Texas Gulf Sulphur Co.*⁸⁵ In this case the court held that misstatements in a press release issued by a publicly-held corporation, which was not at the time engaged in buying or selling any of its shares, violated rule 10b-5 because they were made ‘*in connection with*’ the purchases and sales being made by shareholders in the open market.

Recognition of a private right of action for fraudulent misstatements under rule 10b-5 raises the possibility that such an action may be brought where the misstatement is covered by another, more specific, provision of federal securities law. Thus, in *SEC*

82 [1971] 404 US 6.

83 *Re Investors Funding* [1980] 523 F.Supp. 563.

84 *Rochelle v. Marine Midland* [1976] 535 F.2d 523 and *Ketchum v. Green* [1977] 557 F.2d 1022.

85 [1968] 401 F.2d 833.

v. *National Securities Inc.*⁸⁶ the Supreme Court held that rule 10b-5 could be applied to misstatements in proxy statements, even though proxy solicitation was governed by specific *SEC* rules under section 14 *SEA*. In other case, the court has held that suit can be brought under rule 10b-5 to recover damages resulting from misstatements in a 1933 registration statement, even though such misstatements give rise to a specific right of action under section 11 *SA*.⁸⁷ Lower courts have also held that such suits can be brought with respect to misstatements in documents filed under the *SEA*, as to which there is specific civil liability under section 18.⁸⁸

The most significant court-imposed limitation on private litigation under rule 10b-5 is the requirement that the plaintiff be either a '*purchaser*' or '*seller*' of securities in the transaction being attacked. However, problems frequently arise where a minority shareholder attacks the sale of a controlling block of stock, at a premium over the current market price, as a '*fraud*' on the minority shareholders. In *Birnbaum v. Newport Steel Corp.*,⁸⁹ one of the earliest cases under rule 10b-5, the court held that the purpose of the rule was to protect purchasers and sellers of securities from being defrauded, and that since neither the minority shareholders nor the corporation had purchased or sold any securities, they had no cause of action.

The '*purchaser-seller*' requirement of *Birnbaum* was reaffirmed by the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*.⁹⁰ In this case, the defendants were obliged under an antitrust decree to offer plaintiffs certain shares in a new company. The plaintiffs alleged that the defendants had violated rule 10b-5 by giving a deceptively pessimistic portrayal of the new company in the prospectus, for the purpose of inducing the plaintiff not to buy the shares. While the facts were highly

86 [1969] 393 US 453.

87 *Herman and MacLean v. Huddleston* [1983] 459 US 375.

88 *Ross v. Robins Co.* [1979] 607 F.2d 545.

89 [1952] 193 F.2d 461.

90 [1975] 421 US 723.

unusual, the court rested its decision denying standing to any person other than a purchaser or seller on the broad policy ground that it would deter ‘*vexatious litigation*’ which

“... *may have a settlement value out of any proportion to its prospect of success at trial...*”

and which may raise

“... *many rather hazy issues of historical fact the proof of which depend(s) almost entirely on oral testimony...*”

Justice Rehnquist's majority opinion is replete with expressions of hostility to private actions against corporate management, leading dissenting *Justice Blackburn* to remark that:

“... *the court exhibits a preternatural solicitousness for corporate well-being and a seeming callousness toward the investing public quite out of keeping.... with our own tradition and the intent of the securities laws...*”

One important exception to the purchaser-seller requirement is that a person whose shares are automatically converted into shares of another company in a merger put through by means of misleading statements is entitled to sue under rule 10b-5 as a ‘*forced seller*.’⁹¹ It should be noted that the courts have continued to apply the ‘*forced seller*’ exception after the Supreme Court decision in *Blue Chip*.⁹²

91 *Vine v. Beneficial Finance* [1967] 374 F.2d 627.

92 *Alley v. Miramon* [1980] 614 F.2d 1372, 1387.

4.3.2. *The English Position*

4.3.2.1. *The Common Law Position*

While such cases as *R v. Aspinall*⁹³ have long recognised the need to criminalize manipulative practices,⁹⁴ on the basis that it provides retribution and increases the deterrent effect, English common law has also allowed investors to sue such fraudsters, albeit in limited circumstances, under the tort of deceit.⁹⁵ This was illustrated in the case of *Barry v. Croskey*⁹⁶ where a number of defendants and a jobber entered into an agreement with the plaintiff jobber to purchase shares in a company. The defendants made a fraudulent representation to the Stock Exchange to obtain a listing for that company and secured allotments for themselves through fictitious names. Consequently, the plaintiff jobber could not obtain shares for delivery and had to pay the defendant jobber certain sums to be released from this contract. The court held that a bill in equity to recover sums paid by the plaintiff would lie if amended to show that the plaintiff discovered the fraud after the payment of those sums. However, in this case it was recognised that a plaintiff could only recover damages if

93 [1876], *supra*, note 26. In this case the defendants were charged with conspiring to falsely obtain a listing of the stock exchange for the purpose of inducing potential investors of believing that the rules of the exchange had been complied with. In similar factual circumstances it was judicially recognised in *Burns v. Pennell* that in such instances the use of the criminal law would be more appropriate than civil law; [1849] 2 HL 497, 525 *per Lord Campbell*.

94 The problems associated with criminalizing financial offences has not just been experienced by the United Kingdom *see*, for instance, Ozawa, E. (1994), 'Market Price Manipulation', Butterworths Journal of International Business and Financial Law, Vol. 9, No. 4, at 53 *et seq.*, which details the problems Japan has encountered in interpreting the criminal law within this context.

95 In reviewing the elements necessary for the tort of deceit to come about *see Viscount Maugham dicta* in *Bradford Building Society v. Borders* [1942] 2 All ER 205, 211.

96 [1861] 70 ER 945.

“... it appear[ed] that such [a] false representation was made with the intent that it should be acted upon by such a third person in the manner that occasions the injury of loss...”⁹⁷

and that the loss must be

“... by the immediate, and not the remote, consequence of the representation thus made...”⁹⁸

Thus, a number of thresholds had to be overcome in order for the potential plaintiff to be rewarded with any remedy. Initially such evidential hurdles dissuaded many from bringing an action under this tort. In particular whether or not the ‘*third person*’ in *V-C Wood*’s second principle should amount to a market purchaser was perceived as a major obstacle. However, when this principle is considered in light of his remarks as to victims in the case of *de Berenger’s* and discussion in *Longridge v. Levy*, it is clear that such a ‘*third person*’ should be ascertained and does not include a stranger/market purchaser. Indeed such an interpretation was also affirmed in the later case of *Salaman v Warner*.⁹⁹ There the plaintiff had sold shares short in a company promoted by the defendants who had made false representations to the Stock Exchange in order to obtain a settling day. The defendant also secured allotment of large bulk of the new shares through nominees and thereby managed to corner the market. As a result of the defendant’s rigging activities, the plaintiff had to purchase the shares at a higher price than expected. The court held that the injury to the plaintiff was too remote, there being no civil right of the plaintiff that had been invaded by the defendant’s conspiracy to rig the market.

⁹⁷ *Op. cit.*, at 953 - 55, per V-C Wood.

⁹⁸ *Ante.*

⁹⁹ [1981] 65 TLR (NS) 951.

However, in a heavily criticised case, *Bedford v Bagshaw*,¹⁰⁰ the court held that the defendants were liable to a purchaser on the market. In that case the defendants obtained a listing on the Stock Exchange by making false representations to the listing committee that two-thirds of the shares had been subscribed. The plaintiff, knowing the rules of the Stock Exchange relied on the representations and purchased shares on the market. The shares turned out to be worthless.

Yet, it is difficult to reconcile *Bedford v. Bagshaw* with the earlier case of *Peck v. Gurney*.¹⁰¹ In that case, the court held that a purchaser on the market could not recover damages from the defendant director's estate since the force of the fraudulent prospectus was exhausted after the allotment of shares. In other words, only subscribers and not subsequent purchasers can sue the perpetrators of fraud for damages.

A later Court of Appeal case seems, however, to qualify the House of Lords decision in *Peck v Gurney*. In *Andrews v Mockford*¹⁰² the Court of Appeal gave relief to investors who had purchased shares on the market if it could be proved that the fraudulent prospectus was intended to induce subsequent market dealings. Despite the fact that preference has been given to *Andrews v Mockford* over *Peck v Gurney*,¹⁰³ the latter, being a House of Lords decision, is nevertheless considered as representing the general principle at common law.¹⁰⁴

The above contention seems to suggest that in order for an investor to claim damages from a market rigger it is necessary to show privity of contract or trust, without which the court would normally deny a remedy on the ground of remoteness.

100 [1959] 4H and N 538 and 157 ER 951.

101 [1873] LR 6 HL 377 at 396 *et seq.*

102 [1896] 1 QB 372.

103 Welch, N. (1985), 'Breach of Prospectus Requirements', *Company Lawyer*, Vol. 6, No. 6, at 249 *et seq.*

104 Clerk, J. and Linsell, K. (1982), *on Torts*, Butterworths: London, at 21 *et seq.*

But such a proposition seems odd for in an action for deceit the issue of privity need not be proven.¹⁰⁵ According to *Viscount Maugham* in *Bradford Building Society v Borders*¹⁰⁶ the elements of deceit are: (i) there must be a representation of facts made by words or by conduct; (ii) the representation must be made with a knowledge that it is false; (iii) it must be made with the intention that it should be acted upon by the plaintiff or by a class of persons which will include the plaintiff in the manner which resulted in damages to him; and (iv) it must be proven that the plaintiff has acted upon the false statement and has possibly sustained loss.

One way of explaining this conundrum was suggested in *Clerk and Lindsell* where it was suggested that:

*“... where a person has acted upon a false representation which was not made directly to him, the practical test whether he was intended to act upon it is whether it was to the defendant’s interest that he should do so. Therefore, where persons spread a false rumour for the purpose of raising the price of certain stock, they will not be liable in damages to those who deal with other persons on the faith of such rumour being true, there being no intention to deceive any persons other than those who dealt with the defendants themselves, inasmuch as the defendants had nothing to gain unless the investors dealt with themselves.”*¹⁰⁷

However, this argument cannot explain cases like *Andrews v Mockford* or *Scott v Dixon* where the plaintiffs succeeded in recovering damages from the defendants despite the absence of a contractual relationship between the two. In the latter case the plaintiff brought shares in a banking company upon the faith of a fraudulent report

¹⁰⁵ *Pasley v. Freeman* [1789] 3 TR 51; 100 ER 500.

¹⁰⁶ [1942] 2 All ER 205, at 211.

¹⁰⁷ Clerk, J. and Lindsell, K. (1982), *supra*, note 104, at 29 *et seq.*

made by the company's directors. Copies of which were left at a bank for distribution. The court held that the directors were liable in damages to the plaintiff.¹⁰⁸

It seems therefore that contractual relationship is not the only situation in which relief can be granted to victims of stock market fraud. Another situation in which damages can be granted, it is submitted, is the case where there exists a direct communication between the market rigger and the plaintiff victim. The point was forcibly put by *Lord Chelmsford* in *Peek v Gurney*:

"... It appears to me there must be something to connect the directors making the representation with the party complaining that he has been deceived and injured by it; as in Scott v Dixon, by selling a report containing the misrepresentations complained of to a person who afterwards purchased shares upon the faith of it, or as suggested in Gerhard v Bates, by delivering the fraudulent prospectus to a person who thereupon becomes a purchaser of shares, or by making an allotment of shares to a person who has been induced by the prospectus to apply for such allotment. In all these cases the parties in one way or other are brought into direct communication; and in an action the misrepresentation would be properly alleged to have been made by the defendant to the plaintiff; but the purchaser of shares in the market upon the faith of a prospectus which he has not received from those who are answerable for it, cannot by action upon it so connect himself with them as to render them liable to him for the misrepresentations contained in it, as if it had been addressed personally to himself..." [emphasis added]¹⁰⁹

This idea of direct communication can also explain *Andrews v. Mockford*. It should be recalled in that case the defendants issued a prospectus a copy of which was sent to the plaintiff. Thus the plaintiff was more than a mere stranger who had

¹⁰⁸ [1959] QB HT.

¹⁰⁹ [1873] LR 6 HL 377 at 399 *et seq.*

purchased shares on the market. He was an ascertained member of a specific class whom the defendant had direct intent to injure. As such, the facts of the case seem to satisfy *V-C Wood's* three principles and *Viscount Maugham's* dictum on the requirement of deceit in *Bradford BS v. Borders*.

In cases involving securities fraud and market manipulation, it seems therefore, for an investor to maintain an action against the market riggers, he will have to work out a relationship with the former either in contract or in some other form of nexus such as direct communication. The court, in a majority of cases, appears as in other areas of tortious liability relating to economic loss, to have exhibited a desire to restrict liability in order to prevent floods of claims from strangers like purchasers on the market.

4.3.2.2.1. *Section 47(1)*

Section 47 creates two categories of offences: in essence subsection (1) concerns misleading statements, whereas subsection (2) concerns conduct creating a misleading impression. However, the two subsections do not seem mutually exclusive, in that a ‘*statement, promise or forecast*’, or ‘*concealment*’¹¹⁰ (caught under subsection (1)) may also constitute an ‘*act or ... course of conduct*’ (caught under subsection (2)). This causes difficulty as subsections (1) requires proof of dishonesty (or recklessness) whereas subsection (2) does not. Thus, it would seem that even honest statements which are not penalised by subsection (1) may be penalised under subsection (2). Thus, it is possible for a company director to be liable under this section if he knows that statement to be misleading; dishonestly conceals any material fact or recklessly makes a misleading statement.¹¹¹

110 It may be argued that the offence by concealment can arise only if it would make what has already been said or disclosed false, misleading or deceptive; *R v. MacKinnon* [1959] 1 QB, at 154:

“*If any fact that is omitted from a statement, promise or forecast is material, it can only be material in that its omission makes what has been said misleading, false or deceptive.*”

111 Past decisions interpreting the comparable provision in the *Prevention of Fraud (Investment) Acts of 1939 and 1958* suggest that dishonestly was required for a person to be guilty when charged under the ‘*knowledge*’ category. Interestingly, the courts, when interpreting similar sections in the 1939 and 1958 Acts took divergent views on whether dishonesty had to be proved when charging a person under the ‘*knowledge*’ category. In *R v. MacKinnon, op.cit.*, the court had to pronounce on the meaning of ‘*recklessly*’ which appeared in section 13 of the 1958 Act. Salman J. took the view that section 13 dealt with three categories of persons.

According to him, there was no difference between categories 1 and 2 because if the omission was dishonest it was only because the person who made the statement knew what was said was misleading, false or deceptive by reason of that omission.

It was not the purpose of the *1939 Act* to include offences which had nothing to do with fraud.

However, in the case of *Bates* [1952] 2 All ER 842 affd sub nom [1953] 1 WLR 77 the word ‘*recklessly*’ was given its full ordinary meaning. As the courts saw it, if ‘*reckless*’ meant something more than carelessness it is not clear why Parliament had not used that word as it had done in the line immediately before. Moreover, in words of *Donovan J.*:

The parenthetical clause in section 47(1)(b) has introduced ambiguity into section 47(1)(a) as it is open to two possible interpretations. On the one hand, following the judgements in *MacKinnon*¹¹² and *Bates*¹¹³, proof of dishonesty may be required to prove a charge of making a false statement or concealing material facts. Alternatively, dishonesty may be only required if the charge is one of concealment.

Recklessness as a mental element is sufficient only in respect of affirmative statements and not omissions. Thus, paragraph (b) qualifies only the statement part of paragraph (a). The words 'or otherwise' in the parenthetical clause are necessary only because, in their absence, dishonesty would be thought of as an essential element of (a) as well. In fact, this was how the requirement of recklessness was interpreted by the court in *MacKinnon*.

On the other hand, dishonesty is explicitly dispensed with only for offences arising from statements recklessly made. By implication, therefore, dishonesty remains as an element of the offence constituted by knowledge. Moreover, at the time the amendment by the parenthetical clause was made to section 13 of the *Prevention of Fraud (Investments) Act 1958*, Parliament would have been cognisant of the decision in *Bates* and *MacKinnon* both of which expressed the view that dishonesty was involved in offences arising from statements knowingly made. Since Parliament amended only paragraph (b), it must be assumed to have acquiesced in the views expressed by the courts on paragraph (a).

"(I)t is not a difficult matter to decide in any given case whether a false statement of fact is false to the knowledge of him who makes it, nor whether a concealment of facts is dishonest. But then the section goes on to deal, among other things, with forecasts which are misleading, false or deceptive. They may be falsified by the events. How, in a majority of cases, could one prove they were made dishonestly, even if such were the case? It would seem understandable therefore for Parliament, intending to do something about them, took the view that as a practical matter, it ought to go a step further than false statements and dishonest concealments of facts, and besides striking at the dishonest prophet, do something to ensure that even the honest ones should take due care to see that their forecasts were not misleading, false or deceptive."

¹¹² *Op cit.*

¹¹³ *Supra*, note 111.

It is submitted that the plain meaning of the words of section 47(1) does not warrant the conclusion that dishonesty is a prerequisite for statements known to be false, misleading or deceptive. If dishonesty did not mean something other than knowledge, it is difficult to understand why the word '*knowledge*' is used in respect of one part of the clause and '*dishonesty*' used in the other.

Dishonesty and knowledge refer to two different though not mutually exclusive states of mind. Dishonesty connotes a state of mind marked by deliberation or wilfulness which are not necessarily involved when a person acts knowingly. It is not necessary to establish that in making a knowingly false statement, a person acted dishonestly. Conversely, he may not be acting dishonestly when making a statement in the knowledge that it is false or misleading. Therefore, it is not necessary to prove that in making such a statement he acted dishonestly.

In practice, however, it will be difficult to prove dishonesty except by reference to his knowledge. Dishonesty, after all, refers to a person's state of mind and, in the absence of a willing acknowledgment of his own dishonesty, it has to be inferred from what he knew and what he did. Thus, a person cannot be said to have acted dishonestly in omitting to divulge facts of which he was unaware. But, if he knew that he was concealing facts which were material to an investment decision, then it would be difficult for him to maintain that he did not do so dishonestly. However, knowledge, like dishonesty, is equally difficult to prove.

In *R v. Ghosh*,¹¹⁴ the meaning of '*dishonesty*' as it appeared in section 1 of the *Theft Act 1968* was considered, and the Court of Appeal determined that it referred to state of mind rather than conduct. Therefore, the test of dishonesty was said to be subjective. Nevertheless, the court held further that the standard of honesty to be applied was the standard of reasonable and honest men and not that of the accused. In other words, if the accused knew that the society at large would believe he was acting dishonestly, then he would be acting dishonestly regardless of his own state of mind.

¹¹⁴ [1982] 2 All E.R. 689.

In *Ghosh*, the court was confronted with two lines of authorities on the issue at hand, one holding that the test to be applied was subjective,¹¹⁵ and the other holding in favour of an objective test.¹¹⁶ The court reconciled the two by regarding the specific mental element of dishonesty as a state of mind but at the same time making it subject to the standard of reasonable men in society. If dishonesty was described as referring to a course of conduct, it could then be established independent of the knowledge or belief of the accused. Instead, the court chose to characterise it as a state of mind. But in applying the test of reasonable and honest men to the accused's belief, the court applied an objective test regardless of what the accused believed.

If the notion of dishonesty were to be judged solely according to the current social mores, a person might be found guilty for not disclosing facts which, by civil law, he is not obliged to disclose. The better view is to regard dishonesty as not only reflecting moral but also legal considerations. Accordingly, in the absence of a legal duty to disclose, dishonesty will not be made out merely because of their non-disclosure.¹¹⁷

Recklessness, '*normally involves conscious and unreasonable risk taking either as to the possibility that a particular undesirable circumstances exists or as to the possibility that some evil will come to pass.*' As in the case of negligence, recklessness involves unjustifiable risk taking but, unlike in negligence, the risk is known. Thus, making a statement regardless of whether facts existed to support it would amount to recklessness.¹¹⁸ The decision in *Caldwell*¹¹⁹ and *Lawrence*¹²⁰ have given a wider meaning to the concept of recklessness. According to *Caldwell*, a

¹¹⁵ *R v. Landy* [1981] 1 WLR 355.

¹¹⁶ *R v. Greenstein* [1975] 1 WLR 1353.

¹¹⁷ *Arlidge and Parry on Fraud*, (1996), London: Sweet and Maxwell, at 218 *et seq.*

¹¹⁸ *R v. Gruwald* [1963] 1 Q.B. 935.

¹¹⁹ [1982] A.C. 341.

¹²⁰ [1982] A.C. 510.

person will be acting recklessly even if he did not actually foresee the particular risk but would have realised the risk had he stopped to think, i.e. not given thought to the possibility of any risk. In the context of section 47(1) a person would be reckless either (i) when he foresees the risk of the statement, promise or forecast, or (ii) fails to give his mind to the possibility of the statement, promise or forecast being misleading, false or deceptive although there is an obvious risk that the statement might be so.

The statement, promise or forecast must be made on the facts concealed for the purpose of inducing another person to enter or offer to enter into, or to refrain from entering or offering to enter into, an investment agreement¹²¹ or to exercise, or refrain from exercising, any rights conferred by an investment.¹²²

It is not a requirement of the offence that the statement be made to, or the facts be concealed from, the person who is induced to enter into or refrain from entering into an agreement. The person to whom a statement and the person who is intended to be induced need not be the same.

Criminal liability under section 47(1) does not arise if certain requirements referred in section 47(4) are absent. Thus, a person is not liable in respect of a statement made from outside the United Kingdom to enter into an agreement outside the United Kingdom. If a statement is made from outside the United Kingdom inducing a person in the United Kingdom, it may result in liability.

¹²¹ See section 44(9) *FSA '86* for the definition of investment agreement cf. section 13(1) paragraph (b) of the *Prevention of Fraud (Investments) Act 1958* under which an offence was made out even if the accused induced another person to take part in any arrangement with respect to property other than securities, and where such arrangements enabled the participation in or receiving of profits or income arising from the acquisition, holding, management or disposal of such property.

¹²² As defined in section 1(3) *FSA '86*.

4.3.2.2.2. *Related Offences*

In a similar vein, section 200 *FSA '86* makes it an offence for a person to furnish information known to be false or misleading or recklessly to furnish information known to be false or misleading or recklessly to furnish information which is false or misleading for the purpose or in connection with any application of the *FSA '86* or in purported compliance with any requirement imposed on him by or under the *FSA '86*.

There is an apparent overlap between sections 47 and 200 *FSA '86*. However, a breach of section 47 must be made for the purpose of inducing. Regarding the secondary market, where the company is not a contracting party, disclosure, arguably, is not at all made for the purpose of inducing, which is a prerequisite for section 47, but rather to keep the market informed or alternatively to comply with the Stock exchange's disclosure requirements. If this argument is accepted, the significance of section 200(1) *FSA '86* comes to the fore and fills the gap that the requirements : '*for the purpose of inducing*' in section 47 *FSA '86* may create with regard to disclosure in the secondary market.

An offence similar to that committed under *Section 200 FSA '86* can also be found in *section 19 of Theft Act 1968*. Under this section an offence is committed where a company's annual accounts are misleading. *Section 19(1)* provides:

"Where an offence of a body corporate or unincorporated association (or person purporting to, act as such) with intent to deceive members or creditors of the body corporate or association about its affairs, publishes or concurs in publishing a written statement or account which to his knowledge is or may be misleading. False or deceptive in a material particular, he shall ... be liable to imprisonment..."

Subject to the provisions of *section 19(3)*, the defendant must be (or purported to be) an '*officer*' of the corporation or association. '*Officer*' is not defined in the *Theft Act 1968*, but the *Companies Act 1985; section 744*, provides that in relation to a company that the expression any director, manager or secretary. This expression is

commonly held to mean any director, manager, secretary or other similar officer of their body corporate and is intended to impose criminal liability only upon those who are in a position of real authority, the decision-makers within the company who have both the power and responsibility to decide corporate policy and strategy.

An auditor is an '*officer*' who is appointed to fill the office of auditor and not merely '*ad hoc for a limited purpose.*' Thus the offence is committed by an auditor who is corruptly dissuaded from qualifying this report. *Section 19(3)* adds:

"Where the affairs of a body corporate or association are managed by its members, this section shall apply to any statement which a member publishes or concurs in publishing in connection with his functions of management as if he were an officer of the body corporate or association"

The *actus reus* of the offence is the publication of a written statement or account which is or may be misleading, false or deceptive in a material particular. The requirement of falsehood '*in a material particular*', in the light of the required mental element, presumably means only that the falsehood must relate to the affairs of the corporation or association. It is also sufficient if the defendant does not publish the statement or account himself but concurs in the publication by someone else. The general belief is that section 19 does not apply to exuberant oral statements by directors to the press, even though those may substantially affect public views of the company. But it is arguable that if a director makes a statement to the press he is '*concurring*' in the statement's subsequent publication.

The *mens rea* of the offence does not include dishonesty. Two elements are required: the first (somewhat superfluously in the light of the second) is knowledge that the statement or account is or may be misleading, false or deceptive; the second is an intent to deceive members or creditors of the corporation or association about their affairs. The intent to deceive, it is submitted, should be construed as an intent to lead members or creditors to believe a proposition which is false.

4.3.2.2.3. Section 47(2)

Unlike section 47(1) *FSA '86* that was originally defined under section 13 of the *Prevention of Fraud (Investments) Act 1958*¹²³ what amounts to market manipulation has no previous legislative roots¹²⁴ although this can now be found in section 47(2) *FSA '86*. Even though section 47(2) only comprises of a mere six lines in the statute book its apparent simplicity and terseness belie the complexity of this market activity and the profundity of its impact on many types of securities transactions. This section states that market manipulation occurs when:

'Any person who does any act or engages in any course of conduct which creates a false or misleading impression as to the market in or the price or value of any investment is guilty of an offence if he does so for the purpose of creating that impression and of thereby inducing another person to acquire, dispose of, subscribe for or underwrite those investments or to refrain from doing so or to exercise, or refrain from exercising, any rights conferred by those investments.'

It applies to any body, whether they be natural or corporate entities irrespective of their authorisation under the *FSA '86*. The subsection is also supplemented by three further provisions relating to defences,¹²⁵ territorial application¹²⁶ and criminal penalties.¹²⁷ Yet, like the forbearer to section 47(1),¹²⁸ section 47(2) has had little

123 Stoakes, D. (1996), *'Asking Leading Questions'*, *Euromoney*, June, at 30.

124 Although similarities can be deduced from section 70 *Securities Industry Act 1970* (New South Wales). Before section 47(2) came into effect any prosecution in this area was carried out under the aegis of conspiracy to defraud; see, for example, *Scott v. Brown, Doering McNab and Co* [1892], *supra*, note 6.

125 Section 47(3) *FSA '86*.

126 Section 47(5) *FSA '86*.

127 Section 47(6) *FSA '86*.

128 Control of manipulative practices have not just been relegated to these two pieces of legislation. Both the Panel on Take-overs and Mergers and the Stock Exchange have general principles

impact on those that seek to use these devices to make money.¹²⁹ Indeed, determining what is a legal or illegal act for the purposes of section 47(2) has not been clear primarily due to the lack of specific case law on this particular point. While there have been calls for clarification on the extent of this section¹³⁰ these have essentially gone unheeded with the result that this section is broadly worded and extensive in scope, a fact that can be advantageous given the number of manipulative practices that exist.¹³¹

One of the most difficult aspects of determining whether market manipulation has occurred for the purpose of section 47(2) relates to the issue of stabilisation.¹³² Stabilising techniques refer to those market operations undertaken which support securities issues at a certain market price and is a practice which is used to prevent outsiders from manipulating certain market conditions, for example, when a security has been recently issued or traded upon in Eurobond markets.¹³³

directed at this practice; '*Market Manipulation; Offences; Take-Overs*', (1988) 3(1) Corporate Briefings, at 2 *et seq.*

129 Ooi, P. (1993), notes that the reasons for failure on the part of the *Prevention of Fraud (Investments) Act 1958* lay with its terms and poor enforcement; '*The Regulation of Share Pushing: A United Kingdom Perspective*', *Company Lawyer*, Vol. 14, No. 11, at 209.

130 See comments made by the Minister for Trade and Industry, *Francis Maude* in relation to take-over bids; *Hansard*, 16/5/89, at 116 *et seq.*

131 However, Lee, H.C. (1993(b)) disputes that this section actually covers '*corner*' or '*squeeze*' devices given that these:

“... involve the limitation of supply but may not necessarily involve an intent 'to induce another' to deal with the securities...”

, *supra*, note 74, at 125.

132 Tennekoon, H. (1989), '*Stabilisation of Securities after the Financial Services Act 1986*', *Butterworths Journal International Banking and Financial Law*, Vol. 4, No. 7, at 304 *et seq.*

133 Shepard, S. (1990), '*Bond Buy-ins and the Law*', *Butterworths Journal of International Banking and Financial Law*, Vol. 5, No. 5, at 198 *et seq.*; Hancock, G. and Maddock, J. (1989), '*Financial Regulation: Eurobonds – Duty to Disclose Successes or Otherwise of Bond Syndication*', *Journal of International Banking Law*, Vol. 4, No. 6, 253 *et seq.* and Horwood, I. (1994), '*How to Massage the League Tables*', *Euromoney*, December, at 30 *et seq.*

Stabilisation is a complex and sophisticated transactional used both on primary and secondary markets. On primary markets stabilisation is usually achieved through the under or over allotment of securities by the appointment of a leading dealer. A number of stabilising techniques may be used by such dealers in order to achieve a particular result. These include the use of '*ramping*', which involves the making of an advanced purchase of securities before their actual issue date has been set thereby pushing or depressing its value;¹³⁴ '*bear squeezes*', achieved when the lead manager under allots to dealers who, in anticipation of their allotment, might have oversold the securities on the market causing their price to fall; or '*short squeezes*', achieved when the lead manager will only sell at a specific price. This former practice has been used on a number of occasions. In 1989 a lead manager employed a short squeeze tactic in connection with Toyota Motor Credit. On this occasion, some dealers, including some members of the syndicate, had sold more bonds than they owned in a hope of buying them back later at a lower price. The lead manager declined to make a public price at which it would sell the bonds saying it would deal only by telephone and that the offer price would depend on who wanted to buy.

Other techniques include the use of:

"... pegging or special bids. Pegging is the placing of a continuous offer at a specified price so that a floor is effectively established. A special bid is a scheme to purchase a specified number of shares around the desired price. [Yet] The danger in stabilisation is that in the case of unpopular issues, it may soak up so much of the float that it looks very much like a

134 This practice was used in the original *Guinness* trial; *Guinness PLC v. Saunders* [1988] 1 WLR 863; Levi, M. (1993), *Royal Commission on Criminal Justice; The Investigation, Prosecution and Trial of Serious Fraud*, Research Study No. 14, HMSO: London, at 219 *et seq.*; *R v. Ward, Howarth, Dolye, Crawford and Pollard* [1995] unreported; see Barnett, A. (1996), '*Fraud Enforcement in the Financial Services Act 1986: An Analysis and Discussion of s.47*', *Company Lawyer*, Vol. 17, No. 7, at 209.

corner or squeeze which [may be] manipulative..."¹³⁵ (amendments added)

Stabilising activities technically can constitute a prima facie contravention of section 47(2) *FSA '86* if it can be shown that its effects are to create a false securities market. However, the *FSA '86* permits stabilisation provided it is effected in accordance with rules made under itself.

This ambiguity causes significant problems in that what may be a legitimate transactions through stabilising techniques may equally be an illegitimate market manipulation.¹³⁶ *Lee* argues that in order to correct this conundrum:

*"... A better approach would be to create a separate offence for the breach of stabilisation rules. This offence should attract a lighter penalty to reflect the lack of an intention to defraud. Emphasis should shift away from the need to prove intention to mislead onto proving failure to disclose which is the primary objection to any allegedly illegal stabilisation..."*¹³⁷

Section 47(2) comprises of a number of other key elements that must be proven in order for a alleged manipulator to attract criminal liability. Thus, the act engaged in by the potential manipulator must create a misleading or false impression. While the latter principle can be satisfied, if viewed by the court, as being objectively mendacious, the former impression has been judicially construed to refer to the incorrect or inaccurate belief an investor will be led to believe is true by a

¹³⁵ Lee, H.C. (1993(b)), *supra*, note 74, at 126. Although it should be noted that market manipulation would only occur if combined with the intention to '*create a false and misleading impression*' in the securities market.

¹³⁶ Although under section 48(7) *FSA '86*, states that nothing done conforming to the Authority's rules, applicable to both directly authorised persons and to SRO members, will be in breach of section 47(2); *see ante*, chapter two.

¹³⁷ Lee, H.C. (1993(b)) *supra*, note 74, at 127.

manipulator.¹³⁸ Ultimately though such an impression is decided on the facts and merits of each case placed before the court. In addition, a defendant will not attract criminal liability if he refrains from engaging in conduct contrary to s.47(2) unlike s.47(1). While the general rule under English Criminal law is that a defendant will not have committed a criminal offence by way of omission unless he is under a duty to act,¹³⁹ it is highly probable that a defendant ensnared under section 47(2) will have to prove that there is no causative link between his actions and the alleged manipulation that has taken place irrespective of any omission on his part.

Section 47(2) covers a vast number of securities transactions that are intended to operate on and off the market floor. However, even if these transactions abide by applicable rules and regulations, the court may still find a defendant liable if he uses any fraudulent means to create the wrong impression to an investor, private or otherwise.¹⁴⁰ This can be deduced if one looks to the United States for guidance. There, the courts have long recognised that even if steps have been taken by the defendant to ascribe to market regulations he will still be liable under the *SEA* if he ultimately creates a false impression when trading he will be found liable under the *SEA*. This was illustrated in the case of *Halsey, Stuart and Co. Inc.*¹⁴¹ where an underwriter, who has been left with a large inventory of unsubscribed shares in a new issue made further purchases in order to make it appear as if there is active trading in that security. In these circumstances he will be found liable of manipulative conduct.

138 *CRW Ltd v. Sneddon* [1972] 72 AR (NSW) 17.

139 Jefferson, M. (1995), *Criminal Law*, Cavendish: London, at 106 *et seq.*

140 Under section 47(2) the phrase '*purpose of creating (an) impression*' can be construed as being satisfied in light of proof of recklessness; the premise being that if the proof of intention be the only criteria the defence under section 47(3) would serve no purpose. Therefore, it would seem appropriate that the decision reached in *R v. Caldwell* [1982] AC 341 will be applicable in such instances where an individual:

- (a) engages in a course of conduct which in fact creates an obvious risk that a false or misleading market will be created; and
- (b) when he engages in that course of conduct either he had not given any thought to the possibility of there being such a risk, or he recognised that there was some risk involved and nevertheless went on to engage in the course of conduct.

141 [1949] 30 SEC 106, 112.

This stems from the conceptional belief that the market should be free and open. Hence, the correct value of any listed security should be arrived at by consensus between bone fide purchasers and sellers. Therefore, if this equilibrium is maladjusted by manipulative conduct this will be unlawful under section 47(2).

Under section 47(1)(b) a defendant will only be liable if it can be shown that he had the requisite mens rea at the time he created such a false or misleading impression. It can therefore be surmised that more emphasis should be placed on the mens rea requirement rather than the actus reus requirement of this offence, although it is accepted that for a defendant to be found liable under section 47(2) it must be proven that he not only had the intention to create an impression as to the market price or value of a security but also that he induced another into dealing in such a security.¹⁴² In order for the former requirement to be satisfied by the prosecution it must be proven that the defendant created an impression as to the value or price of the investment which was knowingly wrong or inaccurate. The latter mens rea requirement will only be satisfied when it can be shown that the defendant either had the intention to create a false and misleading impression. It is also not necessary to show that the defendant acted in any dishonest manner.¹⁴³

The adoption of very broad language in section 47(2) in conjunction with the fact that there have been few cases that have dealt adequately with this section can be perceived as causing problems in relation to defining the working parameters of it determining what should be classed as either legal or illegal. While the altering of securities for legitimate reasons, such as for tax should not attract liability, this point has not yet been severely tested in the United Kingdom's judicial system.¹⁴⁴ Therefore, if such inferences do come within the courts domain the adoption of a more flexible approach similar to that used in the United States and Canada will facilitate matters. With regards to the former jurisdiction the case of *North v. Marra*

¹⁴² *Scott v. Brown* [1892], *supra*, note 6.

¹⁴³ Lee, H.C. (1993(b)), *supra*, note 74, at 124.

¹⁴⁴ Lee, H.C. (1993(b)), *op cit.*.

Developments Ltd,¹⁴⁵ may well provide the United Kingdom's courts with some guidance to those instances where multi-motive trading practices are involved. In this case stockbrokers advising a corporate client on reorganisation of share capital as a preliminary measure to taking over and merging with another corporation, devised a trading scheme to maintain the target price for their client's shares, which were trading at a deflated price. Since there was no disclosure of the scheme, a false and misleading subterfuge of active trading was devised and put into effect, as a result they were held to be in violation of anti-manipulative provisions. It was stated by *Mason J.* that:

*"... Purchases or sales are often made for indirect or collateral motives, in circumstances where the transactions will, to the knowledge of the participants, have an effect on the market for, or the price of, shares. Plainly enough, it is not the object of the section to outlaw all such transactions..."*¹⁴⁶

The Canadian courts, in a similar manner to the American courts have also sought to clarify what actions taken by a trader should be deemed as acceptable market practice, and therefore legal or manipulative, and therefore illegal. The decision reached was that any motive, honest or dishonest, should essentially be derived from circumstantial evidence. Thus, in *R v. Jay*¹⁴⁷ the accused was charged for engaging in a series of transactions in violation of section 325 of the *Canadian Criminal Code*. Evidence was presented of several individual purchases alleged to have been made by the defendant through orders he had placed with his brokers over a considerable period of time. However, the quantity and the purchase price of the orders fluctuated from time to time. In acquitting the defendant, *Roach J.A.* stated:

¹⁴⁵ [1982] 56 ALJR 106.

¹⁴⁶ *Op. cit.*, at 121.

¹⁴⁷ [1965] 2 OR 471; [1966] 1 CCC 70.

*“... In order to succeed the Crown would have to prove, with respect to each of these purchase orders, that a substantially corresponding sale order had been entered by the accused at substantially the same time so that when the purchase and sale of the quantity specified would be completed they would offset one another with no profit to the accused.”*¹⁴⁸

The court stated further that the Crown would have to go further:

“... and prove beyond reasonable doubt that those corresponding purchase and sale orders were entered with intent to create a false or misleading appearance of active public trading.”

This approach was also taken in the case of *R v. MacMillan*,¹⁴⁹ a case which also related to the same provision of the *Code* although interpreted in a less restrictive manner. In this case, the accused was charged for wash trading by way of manipulative trading through family and friends. No evidence was given by the defendant at her trial. However, in the absence of any explanation by her as to her intentions, the court was compelled to find against her, stating that:

*“... in the absence of circumstances which might reasonably lead to another conclusion, the only logical inference to be drawn from her conduct is that her real and dominant intention was to create a false or misleading appearance, of active trading in the shares of Golden Arrow. The suggested intent to benefit friends could amount to no more than a mere subsidiary consideration.... For these reasons, the appeal against conviction must fail...”*¹⁵⁰

¹⁴⁸ *Op. cit.*, at 473.

¹⁴⁹ [1968] 66 DLR (2d) 680.

¹⁵⁰ *Op. cit.*, at 687.

Additionally, in the case of *R v Lampard*¹⁵¹ involving a charge of 29 accounts of wash trading the court relied on the proposition that the defendant must have intention to be able to foresee the consequences of his actions. *McLennan J.A.* said of the defendant:

*"...He had been in the brokerage business for many years and must be taken, in the absence of evidence from which some other reasonable explanation may be inferred, not only to have foreseen that each wash trade would create a false appearance of active public trading but to have intended that result..."*¹⁵²

At common law, the prosecution need not prove that the defendant intended to defraud a specific person, as was the case in *de Berenger*, it is impossible to know who would become purchasers of the security being rigged. It is not clear from the wording of section 47(2) whether it is necessary for the prosecution to establish that the defendant intended to induce a specific person to deal with him. Arguably this subsection should follow the common law position, for to rule otherwise will unduly restrict the scope of the provision in protecting the investors. It is therefore submitted that in a case where fraud is aimed at the general public (or a class thereof) it will be sufficient to demonstrate that the defendant intended to affect the investors in general (or a class thereof).

There is under subsection (3) a defence available to the accused if he reasonably believed that his act of conduct would not create a false or misleading impression. Thus the test for liability is mainly subjective - whether the accused honestly believed his act or conduct would create a false impression - depending upon the objective safeguard that such belief must be '*reasonable*'. In determining whether the accused's belief was reasonable or not, presumably it is not the standard of the ordinary investor that will be used; rather the question should be whether a person in the accused's

¹⁵¹ [1968] 2 OR 470.

¹⁵² *Op. cit.*, at 476.

circumstances would have held the belief, taking into account all the accused's characteristics.

Proof of subjective belief may appear to be difficult. However, if the accused's conduct is such that no reasonable person in his position would have held that belief, then there exists powerful evidence that he did not honestly hold that belief. The standard of proof required for the defence under the subsection would be a balance of probabilities. It should be noted that the prosecution would need to prove all the ingredients in section 47(2) beyond reasonable doubt before the burden of proof shifts to the accused, in the event that he desires to avail himself to the subsection (3) defence.

Under section 47(6), a person guilty of an offence under section 47(2) is liable to up to seven years imprisonment or a fine or both. In addition, under section 61(1) the court may grant an injunction on application from the Authority or the Secretary of State to restrain a person from infringing section 47(2). However, the *FSA '86* does not expressly provide a civil remedy for violating section 47(2) that can be directly enforced by those putatively injured by market manipulation.

4.4 Summary

Aware of the damage they could do to the orderly functioning of securities markets, securities laws seek to penalise misleading statements, market manipulation and other related activities. With regards to the first type of abusive practice both the United Kingdom and United States have adopted the use of civil remedies as a way of compensating individuals who have suffered damage. Such civil remedies are built on common law remedies and to that extent display the inadequacies which are seen in common law.

In the United States, the civil remedies are seen as having not merely a compensatory but a deterrent function as well. The same cannot be said of English Law. The *FSA '86* relies on the criminal provisions of section 47 to deter misleading statements. American law focuses on the registration process and relies on civil remedies.

One way in which the law seeks to limit this kind of abuse is by imposing upon issuers of securities and other collateral participants involved in its sale a duty to disclose all material information which will enable investors to make an informed choice whether or not to buy the securities. A regime of administrative controls, supplemented by civil and criminal liabilities, ensures that these obligations are complied with. Common law and statutory law give the shareholder of a company the right to information about the company's affairs, but this is a limited right and is available only to shareholders. No such right is available to an investor. The seller must not utter falsehood or mislead but there is no obligation to speak. However, statutory developments in this field have virtually rendered the principle of *caveat emptor* irrelevant.

Like insider trading legislation, the adoption by the United Kingdom and United States of two dissimilar approaches to legislating against stock market manipulation is evident. The broad brush approach, as exemplified by the United States Rule 10b-5 widely contrasts with that adopted by the United Kingdom, which seeks to set out the nature of the offence in more detail. Ironically, the *FSA '86* is still seen as vague and

its generality has caused much uncertainty in practice. What is needed seems to be either a far more detailed form of legislation, as adopted by the likes of Australia¹⁵³ or Hong Kong, outlining in detail what does and does not constitute market manipulation, or the adoption of a more flexible approach,¹⁵⁴ as in the United States and Canada, by the judiciary in widely interpreting legislation.¹⁵⁵

With the possibility of legislative change in the future, it is hoped that the that the ambiguity caused by section 47(2) *FSA '86* will be averted. The present form, with the lack of judicial impetus has left this section stagnant in comparison to insider dealing legislation. The legislature should embrace a forward thinking attitude so as to produce a statute that allows new forms of manipulative practice to be caught. Such an opportunity could also provide a period for the role of the judiciary in implementing such laws to be developed. Indeed, the roles of the criminal and civil law should equally be considered when determining what form of sanction should befall a particular form of manipulative practice. In this respect, the severity of such a practice should, like insider dealing, gauge which form of sanction should be implemented.

¹⁵³ Ashworth, J. and Miller, R. (1997), '*City Star at Heart of Nomura Inquiry*', *The Times*, 6/3/97.

¹⁵⁴ Widholm, B. (1997), '*Sweden: Securities – Market Manipulation*', *International Company and Commercial Law Review*, Vol. 8, No. 3, at C52 *et seq.* were comments on the new controls imposed on existing market legislation.

¹⁵⁵ '*Spotlight Falls on Market Manipulation*', 10(8) *Compliance Monitor*, (1998), at 337.

Section Three

This third, and final, section examines the issues related to the detection, investigation and prosecution of insider dealing and market manipulation. Its purpose is to identify the fundamental problems associated with these essential areas and offer, where possible, practical solutions that if implemented may resolve many of the shortcomings presently experienced.

The purpose of chapter five is to examine the problematic issues surrounding the effective regulation of the financial markets of the United Kingdom. Comparative analysis with the United States is used in this respect to compare the two jurisdictions and speculate whether any ideas utilised under the Financial Service and Markets Bill will have any beneficial effects.

Chapter six assesses the suitability and effectiveness of the criminal law and criminal justice system in dealing with issues related to market abuse. Thus, the value and effectiveness of the implementation of the criminal law is critically examined in conjunction with the problems faced in prosecuting through the adherence to standard procedural and evidential rules.

Lastly, chapter seven seeks to examine the problems associated with extraterritoriality in the context of how the use of one or more jurisdiction can affect the chances of successful detection, investigation and prosecution of insider dealing and issues of manipulation.

Chapter Five

Regulatory Enforcement

Overview

In order for any law to be effective it must possess two distinct yet entwined properties. The first can be said to revolve around the notion of legitimacy,¹ in that laws that promote order and stability influence market behaviour.² Market participants therefore are seen to comply with such laws out of a general willingness rather than because of the fear of sanctions. The notion of legitimacy thus can be viewed as the combination of moral as well as normative aspirations displayed by both internal and external market bodies.³

The second of these qualities relates to the notion of enforcement. In that:

"... the inclination to forgo economic opportunity simply in order to act legally is obviously slight, unless circumvention of the formal law is strongly disapproved by a powerful convention, and such a situation is not likely to arise where the interests affected by a legal innovation (such as a new law) are widespread..."⁴

It is generally acknowledged that the notion of regulatory enforcement in the United Kingdom is weaker than in other jurisdictions. This lack of effective investor protection can be predominantly put down to the fact that self-regulation, deficiencies in the enabling statutes and an ardent resistance to change have long existed. Yet,

¹ Beetham, D. (1991), *The Legitimation of Power*, London: Macmillan, at 20 et seq..

² *Op. cit.*, at 32 et seq..

³ *Supra*, note 1, at 25.

⁴ Rheinstein, J. (ed.) (1966), *Max Weber on Law in Economy and Society*, London: Macmillan, at 38.

given the importance now placed on adequate regulation providing a competitive edge other markets,⁵ how will the radical overhaul in the form of the Financial Services and Markets Bill cope? Now more than ever the financial markets of the United Kingdom need to be more unified so that a convergence of new and more effective implements of enforcement can be introduced. Indeed, given the recent change in government, amendment to the present regime has become a reality, yet will this model be better than the last? The purpose of this chapter is, therefore, to explore, using comparative analysis with the United States, how this jurisdiction can make the present regime of regulatory enforcement more effective without stumbling on issues of over-regulation. This is achieved by dividing this chapter into four sections. Section one examines the general underlying problems associated with detection of insider dealing and market manipulation in the United Kingdom. Section two generally examines enforcement issues in the United Kingdom. Section three uses comparative analysis to assess whether the model of enforcement utilised in the United States offers any insight into any general way the new enforcement regime⁶ being presently implemented in the United Kingdom can be improved upon. Finally section four examines the implications of the impact of the Financial Services and Markets Bill and discusses the main criticisms associated with it.

⁵ McCathery, T. (ed.) (1993), *Corporate Control and Accountability*, London: Macmillan, at 14.

⁶ As mentioned in chapter one, the model upon which regulatory enforcement will be critically assessed upon the model espoused by Fishman; see Fishman, L.J. (1993), 'A Comparison of Enforcement of Securities Law Violations in the United Kingdom and United States', *Company Lawyer*, Vol. 14, No.9, at 163.

5.1. The Underlying Problems Associated with Detecting Market Misconduct in the United Kingdom

Regulators and the legislator have often had problems defining the correct equilibrium for vetting firms.⁷ If vetting requirements are too strict they will inhibit market trading by preventing new firms from entering the market. Alternatively, if too loosely defined they will allow those who are supposed to be kept out in.⁸ Indeed, this dilemma is further exacerbated where an individual in a position of trust may decide to '*step over the line*' and acts in a fraudulent manner.⁹

Of all securities offences committed insider dealing and manipulative practices have long proven to be the most elusive to detect.¹⁰ The reasoning behind this can be put down to a variety of key factors. As both offences are of a '*private*' rather than public nature little visible evidence of their commission exists.¹¹ Even when suspicious securities transactions are detected there is no guarantee that an investigation can be mounted because it is not uncommon for market abuses like these to be scattered and enshrouded by other market transactions.¹² Indeed, because of the form taken by these types of offence the majority are detected in a sporadic manner.

The majority of formal investigations by regulatory bodies are usually initiated by nothing more than the apparently coincidental movements in a share price prior to

7 Section 3 FSA '86.

8 Rider, B.A.K. (1990), '*Policing the International Financial Markets - An English Perspective*', Brooklyn Journal of International Law, Vol. 16, at 179.

9 Thomson, S. (1996), '*US Compliance Chief Accused of Inside Deal*', *The Times*, 31/5/96.

10 This especially true in relation to insider dealing; Naylor, J.M. (1990(a)), '*The Use of Criminal Sanctions by United Kingdom and United States Authorities for Insider Trading: How can the Two Systems Learn from Each Other? Part I*', Company Lawyer, Vol. 11, No. 3, at 54.

11 Croall, H. (1992), *White Collar Crime*, Milton Keynes: Open University Press, at 12.

12 Brummer, A. (1995), '*City Medicine Fails to Halt Epidemic*', *The Guardian*, 16/12/95.

some particular development¹³ that is generally picked up by computer surveillance equipment.¹⁴ Alternatively, tip-offs from market forces or reports from suspicious public investors may be used. Although a certain amount of value that can be attached to this latter form of detection, as reliance on them can add validity to some rumour,¹⁵ information also carries the risk of turning out to be nothing more than speculative or malicious. In this respect some are a waste of time and resources. Yet, general information from genuine investors or market participants can often be abated by a distinct reluctance especially when rumours turn out to be unsubstantiated and the individuals are likely to be viewed as foolish or where investors may incriminate themselves because of less than honest past dealings.¹⁶ Whether these arguments are plausible is extremely hard to prove or disprove due to the surrounding circumstances, although it may contribute in explaining why so little visible evidence exists. Detection may also be compounded by the fact that, in the United Kingdom, a large proportion of trading occurs on secondary markets. Therefore, investigating bodies need not only possess superior expertise over perpetrators but also an adequate time allowance of weeks, months or even years to unravel sometimes highly complex market deceptions.¹⁷ Invariably, given the technological advances that exist, a large proportion of these investigations come up against jurisdictional conflicts that further exacerbate matters.

¹³ Harding, P. (1995), '*Insider Dealing Fears Pursued*', *The Financial Times*, 7/7/95 and Donovan, P. and Beavis, S. (1995), '*New Shares Bonanza for Power Chiefs*', *The Guardian*, 8/7/95.

¹⁴ Levi, M. (1993), *The Royal Commission on Criminal Justice: The Investigation, Prosecution and Trial of Serious Fraud*, (1993), at 62.

¹⁵ Graham, G. (1996), '*Stanchart Inquiries Over Bid Rumours*', *The Financial Times*, 3/2/96. Note that in this area auditors have often been called upon to act as '*whistleblowers*' - a task which they have not relished given that it can undermine confidential relations with their clients as well as increase the chance of their liability should they fail to report matters which is later considered should have been reported; see section 109 FSA; *House of Commons Debates, Hansard*, 28/6/95, at columns 910 - 913. In addition, see Sarker, R. (1995), '*Blowing the Whistle on Fraud*', *Journal of Financial Crime*, Vol. 3, No. 2, at 185.

¹⁶ See generally Mann, K. (1985), *Defending White Collar Crime*, New Haven: Yale University Press.

¹⁷ Although this aspect has been severely criticised; *House of Commons Trade and Industry Committee: Third Report on Company Investigations*, (1990), at xiv. Also see, Cusick, K. (1995), '*Guinness Judges Scales Mountain of Evidence*', *The Independent*, 21/10/95 and Blackhurst, G. (1996), '*Anglia Shares Inquiry Targets Brokers*', *The Independent*, 20/5/96.

The implementation of the most appropriate laws combined with effective enforcement to deal with market fraudsters are highly desirable qualities in any regulatory system. However, if financial resources are constrained the prevailing result will usually lead to a lower rate of detection and prosecution, which, in turn, undermines the deterrent and preventative value of the types of law used against such practices.¹⁸ Accordingly, there have been many calls, not at least from enforcement agencies themselves, for increased resources. Yet, whether the allocation of extra resources will prevent a further escalation of these types of fraud is debatable given that their annual growth rate is so rapid. However, *Levi* has provided a number of arguments in support of increasing resources for the policing of commercial fraud that can equally be applied to securities fraud. He suggests that while the contribution of investigation work for many conventional crimes are negligible, allocating more resources to such agencies *would* increase the amount of fraud detected through more leads being followed up.¹⁹ This, in turn, could increase the credibility and effectiveness of such agencies, which may lead to more victims reporting more offences. Finally, there may be some political benefits in increasing detection rates, although *Levi* notes that there are beneficial limitations in the cost effectiveness of policing such markets.²⁰

Although suspicious market transactions can be detected by an assortment of regulatory bodies only two can be perceived to have actively sought to enhance their abilities in this respect. Thus, the surveillance department of the London Stock Exchange²¹ and the Securities and Futures Association (the 'SFA') have sought to improve their efficiency by respectively adopting the use of artificial intelligence to

18 Beyleveld, D. (1992), '*Deterrence Research and Deterrence Policies*', in Von Hirsch, A. and Ashworth, A. (eds.) (1992), *Principled Sentencing*, Boston: Northeastern University Press, at 78 *et seq.*

19 In 1990 the average cost spent on insider dealing cases was £100,000; *House of Commons Trade and Industry Committee: Third Report on Company Investigations*, (1990), at xxxv.

20 Levi, M. (1987), *Regulating Fraud: White Collar Crime and the Criminal Process*, London: Tavistock, at 280 *et seq.*

21 Ashworth, J. (1995), '*Criminal Inquiries at Record*', *The Times*, 28/9/95 and Hamilton, K. (1996), '*Exchange Calls for Civil Action Over Insiders*', *The Times*, 3/3/96.

predict more accurately when suspicious trading has occurred²² as well as trading suspensions to prevent leaks of price sensitive information²³ and implementing swifter ways of punishing City wrongdoers.²⁴ Interestingly while investigating bodies work within the confines imposed by particular laws they can be seen to utilise them strategically '*bargaining and bluffing*' the majority of small-time offenders.²⁵ Therefore, the '*sledgehammer*' of criminal prosecution is used only as the ultimate threat to encourage compliance²⁶ against the most serious offenders.

However, laws and rules that seek to impose compliance can be significantly affected by external factors. These include conflicting interests, competitive rivalry between regulatory agencies in sanctioning offenders and a general lack of communication which has led to a system that many believe is '*fragmentary*' in nature,²⁷ with an overlap of case jurisdiction and interest.²⁸ This is further exacerbated by the fact that some enforcement bodies are run by Government departments who consequently influence departmental policies and also intervene in individual cases. In some serious cases both Ministerial and Governmental

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- 22 Gapper, J. (1996), '*Stock Exchange Steps Up Insider Dealing Offensive*', *The Financial Times*, 20/5/96; Gapper, J. (1996), '*Exchange's Artifice Fights Crime*', *The Financial Times*, 21/5/96; Eisenhammer, I. (1996), '*Insider Trading Blitz: Exchange Lobbies for Changes that would Introduce Fuzzy Software Spy*', *The Independent*, 21/5/96; Kane, F. (1996) '*High-Tech Detective Hunts Insider Dealers*', *The Times*, 26/5/96; Kane, F. (1996), '*Scourge of the Insiders*', *The Times*, 26/5/96; Brummer, A. and Atkinson, D. (1996), '*Insiders Face 'Big Brother'*', *The Guardian*, 3/6/96 and Moran, M. (1996), '*Survey FT IT: Stock Exchange Gets Fuzzy Logic*', *The Financial Times*, 4/9/96.
- 23 Pangalos, S. (1995), '*Shame Halts Threatened in Fight on Insiders*', *The Times*, 27/1/95; Atkinson, D. (1995), '*Crackdown on Insider Dealing*', *The Guardian*, 27/1/95 and *The Lex Column: Insider Dealing*, *The Financial Times*, 28/1/95.
- 24 Cohen, N. (1995) '*SFA Chief Calls for Streamlining*', *The Financial Times*, 18/5/95 and Cohen, N. (1995), '*SFA Seeks Swifter Punishment for City Wrongdoers*', *The Financial Times*, 20/6/95.
- 25 See generally Hawkins, K. (1983), '*Bargain and Bluff - Compliance Strategy and Deterrence in the Enforcement of Regulation*', *Law and Policy Quarterly*, Vol. 5, at 35 *et seq.*
- 26 See generally Ogus, A. and Veljanowski, E. (1994), *Readings in the Economics of Law and Regulation*, Oxford: Clarendon.
- 27 '*How Many Regulators?*', (1996) *Company Lawyer*, Vol. 17, No. 2, at 34.
- 28 *Roskill Committee Report on Fraud Trials*, (1986), London: HMSO, at paragraph's 2.1 and 2.47 and '*The Lex Column: City Regulation*', *The Financial Times*, 21/2/95.

intervention is evident.²⁹ Indeed, the issue of prosecution can become politically controversial; an underlying factor that may account for the general ambivalence displayed by some agencies. This can be aptly illustrated in the investigation of Lord Archer for insider dealing where concern was expressed that the decision as to whether or not to prosecute Lord Archer lay with another Conservative politician, Michael Heseltine.³⁰ However, very little is still known about the criteria that underlies such decision making policies and processes.³¹

29 Hawkins, K. (1990), 'Compliance Strategy, Prosecution Policy and Aunt Sally: A Comment on Pearce and Tombs', *British Journal of Criminology*, Vol. 30, No. 4, at 456 and Levi, M. (1993), *The Royal Commission on Criminal Justice: The Investigation, Prosecution and Trial of Serious Fraud*, Research Study No. 14, at 20 and 70 *et seq.*

30 White, M. and Donovan, P. (1994), 'Archer is Cleared of City Scam', *The Guardian*, 29/7/94. See also Waller, D. (1997), 'DTI Silent on Insider Inquiry', *The Times*, 27/1/97 where it was reported that two top fundraisers for the Conservative Party had been drawn into an insider dealing inquiry.

31 See generally Clarke, M. (1986), *Regulating the City: Competition, Scandal and Reform*, Milton Keynes: Open University Press. Also see, Olins, N. (1996) 'Think Tank Targets Insiders', *The Times*, 30/6/96; Hamilton, K. (1996) 'Exchange Calls for Civil Action Over Insiders', *The Times*, 3/3/96; Atkinson, D. (1996), 'Regulators Seek Wider Insider Net', *The Guardian*, 1/3/96; Ashworth, J. (1996), 'SIB Considers Move to Make Insider Trading Civil Wrong', *The Times*, 1/2/96.

5.2. *The Process of Enforcement in the United Kingdom*

The starting point of any investigation relating to insider dealing or market manipulation must be founded on reasonable suspicion. In both the United Kingdom and the United States irregular trading activities are detected by a mixture of internal and external bodies whose purpose it is to have both a proactive and reactive effect on financial markets.³² The latter effect is achieved by the surveillance and reporting of any unusual transactions to the appropriate authorities so that they can be more fully investigated and accordingly punished. The former is achieved through the use of compliance strategies to produce a '*deterrent factor*', that is the use of techniques that are:

“... *pre-monitory [devices which attend] to conditions that induce conformity or to foreboding of harm...*”³³

The positive correlation between those that have access to information that is price sensitive and incidences of insider or manipulative activities suggests that securities firms, which are the original keepers of such information, must have adequate control of their responsibilities. In order to achieve this compliance officers, compliance and annual compliance reviews³⁴ have been adopted not only to avoid embarrassing incidences that may involve securities firm being linked with such illegal activities but also to avoid expulsion or suspension from market trading.³⁵

³² See generally Hawkins, K. and Thomas, A. (eds.) (1984), *Enforcing Regulation*, Oxford: Clarendon.

³³ Reiss, A.J. (1984), '*Selecting Strategies of Social Control over Organisational Life*', in Hawkins, K. and Thomas, A. (1984), *op. cit.*, at 27 *et seq.*

³⁴ For rulebook requirements, see FSA Principle 9; Rule 34 of the Core Conduct of Business Rules 34 and those rules made under the rulebooks of the various SRO's which apply to their members and supplement the Core Conduct of Business Rules, such as SFA Rule 5-51 or IMRO Rule 1.5(2).

³⁵ In order to understand the role of compliance officers see generally Bosworth-Davies, R. (1992), '*Practical Training for Compliance Officers: An Assessment*', International Journal of Regulatory Law and Practice, Vol. 1, at 34. Also see Weait, M. (1993), '*The Contribution of the Compliance Function of Effective Financial Services Regulation*', Journal of Asset Protection and Financial Crime, at 83.

Consequently, compliance officers are often one of the first parties to initially suspect that something is wrong. This may have been deduced through scrutinising an account type, security or group of securities, unusual price fluctuation or intuition. Any investigation by compliance officers should receive the full co-operation of senior management as it is in the interests of that firm to make sure that its reputation remains untainted.³⁶ Yet, the inevitable barrage of problems they invariably have little control over can frustrate compliance officers. Establishing the existence of organised rings, for instance, is hard to detect.³⁷ Indeed, given that the primary duty of any compliance officer is to the investigation of their own firm, the impetus to act further may be lacking. To rectify this position compliance officers not only need to co-operate more, but have the incentive to develop a more comprehensive network than already exists. This would then allow them access to a more enhanced pool of information relating to other securities firms.³⁸ The present system can generally be seen to be under-subscribed, under-resourced and poorly managed. The compliance officer may lack the determination needed to succeed; facts which may be put down to the prevailing attitude of some officers.³⁹

Investigations in the United Kingdom are carried out by a varied array of bodies that rely on the powers bestowed upon them by various statutes. The use of *Self Regulatory Organisations* (the 'SRO's'), the surveillance unit of the *International Stock Exchange* (formally known as the '*Insider Dealing Group*')⁴⁰, the *Take-over Panel*, the *Serious Fraud Office* (the 'SFO'), the *Crown Prosecution Service* (the 'CPS'), the *Financial Services Authority* (the 'Authority') and the *Department of Trade and Industry* (the 'DTI') all have separate and/or combined roles in the

36 While it will generally be the case that compliance officers should not come up against opposition by the firm that employs them, this is not always the position. See, for example, *Re a Company's Application* [1989] BCLC 462.

37 On the effect of organised rings on investigations, see generally *R v. Cohen and Greenwood*, unreported, *The Financial Times*, 24/1/90.

38 Hannigan, B. (1994), *Insider Dealing*, London: Kluwer, at 24 *et seq.*

39 Bosworth-Davies, R. (1994), '*Policing Insider Dealing – The Self-Regulatory Regime*', *Company Lawyer*, Vol. 14, No. 6, at 112.

investigating of insider dealing and market manipulation depending upon the issues that may be thrown up during an investigation.⁴¹ However, the last three bodies can be viewed as dealing with the prosecution of these offences.

By contrast, all investigations carried out in the United States are done so by the *Securities and Exchange Commission* (the 'SEC'), whose primary function in this context is to bring enough evidence together so that a charge may be brought against those suspected of insider dealing or manipulative practices. Unlike the United Kingdom regulators, the SEC has no powers to prosecute under criminal jurisdiction. Emphasis here has been placed on bringing such fraudsters to justice via the use of administrative proceedings and civil law. Although the power to bring about a criminal prosecution does exist it is initiated and dealt with not only by a different department - the *Department of Justice* - but only used in those instances where such activities are of an extremely serious nature. Moreover, if the defendants in such cases are successfully prosecuted a private plaintiff may use the findings of the criminal case to prove his own civil case.⁴² Judging by the number of offenders penalised under such an enforcement regime it has been argued on numerous occasions that the United Kingdom could improve its prosecution rate by adopting a similar strategy to that of the United States. However, attitudes in this country must change for as impetus, ignorance and naiveté has long dominated.⁴³ While it has been standard policy amongst the Conservative Party not to enact any new or radical form of regulatory or legal change, the Labour party has long advocated the opposite.⁴⁴

40 *'Insider Dealing and Investor Confidence'*, April (1990), Stock Exchange Quality of Markets Quarterly Review, at 26.

41 *Gore-Browne on Companies*, Supplement 16, at paragraph 12.31.

42 Cottrell, H. (1986), *'Insider Dealing in the United States: Part I'*, New Law Journal, Vol. 136, at 90 *et seq.*

43 Fishman, L.J. (1993), *supra*, note 6, at 171.

44 Miller, V. and Sherman, K. (1997), *'One Watchdog to Monitor All City Dealings'*, *The Times*, 21/5/97; Graham, G. (1997), *'Bank to Lose Supervisory Role'*, *The Financial Times*, 21/5/97 and *House of Commons Debates*, 1993, volume 222, at column 878, (Mr Tony Blair).

In recent years *SRO*'s have played an increasing important role in the monitoring and surveillance of those firms associated with them. Yet, this has been tainted by the questionable competence of some *SRO*'s given the number of frauds that have subsequently developed due to haphazard monitoring and investigating.⁴⁵ Even though the *Authority* possesses a number of provisions⁴⁶ that can be utilised to enforce *SRO*'s to comply with their duties these are seldom used.⁴⁷ This illustrates the general irresolute attitude of those involved in enforcing regulation.

Yet with an element of foresight a fair proportion of the problems now encountered could have been avoided. During debate on the *Financial Services Bill* concern was voiced that with having (at the time) five *SRO*'s, there was bound to be an overlapping of duties and responsibilities.⁴⁸ The fear was that unscrupulous firms could join the regulatory organisation which best suited their business interests tempered with the weakest form of regulation.⁴⁹ Concern was also raised regarding competition between bodies that might hinder investigations and prosecutions.⁵⁰ Although originally stating that the concern was misplaced⁵¹ all the problems envisaged have materialised. However, given the general historic attitude of those involved in City affairs, of which the majority possess a Conservative background, it is not surprising that this route was followed.

45 *Post.*

46 Sections 11-13 *FSA* '86.

47 Lee, 'Market Manipulation in the United States and United Kingdom', *Company Lawyer*, Vol. 14, No.7, at 123.

48 Levi, M. (1993), *The Royal Commission on Criminal Justice; The Investigation, Prosecution and Trial of Serious Fraud*, Research Study No. 14, London: HMSO, at 65-66 and *Roskill Committee Report on Fraud Trials*, (1986), at paragraph 2.1. cf section 10(3) *FSA* '86 where the 'scope' rule provides a means of reducing overlap.

49 Hurst, T. (1984), 'Self Regulation v. Legal Regulation', *Company Lawyer*, Vol. 5, at 161 and *Commons Parliamentary Debates*, (1986), Standing Committee 'E', at column 145.

50 *Roskill Report* (1986), *supra*, note 28, at paragraph 2.47.

51 *Commons Parliamentary Debates* (1986), *supra*, note 49, at column 187.

Although three *SRO*'s now presently exist only the *Securities and Futures Authority* ('*SFA*') and the *Investment Management Regulatory Organisation* ('*IMRO*') have seem to have gained the most media attention in relation to their encounters with insiders and manipulators. However, this is to be expected given their area of jurisdiction. Each *SRO* has incorporated within it various units that monitor and, where appropriate, bring civil⁵² or administrative proceedings against market offenders. However, if the circumstances under investigation are of a complex nature, these will be passed over to another body, such as the *Authority*⁵³ or *DTI* for further, in-depth investigation.⁵⁴ Since 1991 all *SRO*'s have made public all disciplinary measures taken against member firms in the belief that many firms '*teetering on the brink*' of breaking those rules relevant to them will fear the adverse publicity rather more than the fine imposed if caught. The publication of results also stems from the belief that it shows *SRO*'s to be doing something against such breaches.⁵⁵ The use of publicity therefore can be perceived as a highly effective means of deterrent.⁵⁶

52 Section 61 *FSA* '86.

53 Sections 104-5 *FSA* '86. Section 105 derived powers are very similar to that of the *DTI*'s powers under section 177 except that the *SIB* does not have the power to examine witnesses under oath. Section 105 powers are also available to the *DTI* under section 114(8) *FSA* '86 and the *Financial Services Act 1986 (Delegation) Order 1987 (SI No. 942)*.

54 "Routine regulatory mechanisms should not.....be fenced with criminal sanctions. Automatic civil surcharges and penalties are more appropriate, and more reliable in their application"

; Levi, M. (1984), '*Business Regulatory Offences and the Criminal Law*', *Company Lawyer*, Vol. 5, at 252.

55 Borrie, G., Sir (1982), '*Laws and Codes for Consumers*', 88 *Monthly Review*, Vol. 88, where it is argued that deterrence could be undermined by the absence of prosecutions; cf. Clarke, M. (1987), '*Prosecutorial and Administrative Strategies in the Control of Business Crime: Private and Public Roles*' in Shearing, C. and Stenning, M. (eds.) (1987), *Private Policing*, London: Sage Publications. However, note Braithwaite, J. (1989), who argues that to be effective self-regulation should be backed by stiffer penalties. Self-regulation should attempt to foster corporate cultures in which an absence of compliance is seen as morally wrong, and should be based on trust and co-operation, involving all employees; *Crime, Shame and Re-Integration*, London: Routledge, at 146 *et seq.*

56 On the positive effects of publicity as an effective deterrent, see Box, S. (1983), *Power, Crime and Mystification*, London: Tavistock; Fisse, B. and Braithwaite, J. (1983), *The Impact of Publicity on Corporate Offenders*, Albany: State University of New York Press and Benson, T. (1985), '*Denying the Guilty Mind: Accounting for Involvement in a White Collar Crime*', *Criminology*, Vol. 23, at 583. However, the tendency to neither deny nor confirm that an

While both the *SFA* and *IMRO* have a variety of powers at their disposal it seems that it is only the *SFA* that has the determination in the past to use these powers to their full extent.⁵⁷ Such powers allow each *SRO* to fine, cease trading, or take hold of any assets of any member firm it believes has breached the relevant rules that relate to it.⁵⁸ Indeed, support exists for an extension of these powers to deal with insider and manipulative activities in instances where such activities are relatively small in both size and financial gain. However, although this line of thought offers a possible solution to the problems associated with the prosecution of these types of offences it also presents problems that have not yet been encountered under the present regulatory enforcement system.⁵⁹ As *SRO*'s are not empowered to bring criminal prosecutions against insider and manipulative activity, the only form of redress *SRO*'s have against these individuals is via the civil law through a contractual breach of those member rules that relate to that individual's activities. However, in order for this to come into effect the *SRO* concerned must make a request to the *Authority* in order for this action to be initiated. Once this is granted, though, it presents to the *SRO*, evidential and procedural problems aside, with what many see as a formidable weapon that can be used against these types of activity.

The surveillance unit of the *International Stock Exchange* primarily deals with the investigation of insider dealing.⁶⁰ Although manipulative practices may also be

individual is being investigated can have a detrimental effect on that persons character, which in the City counts for much:

'... These inquiries are always lengthy and often inconclusive. Their names may never be fully detached from this investigation in the public mind because of the DTI's self-imposed code of silence. This has happened before in insider dealing inquiries, and it is quite unjust.'

Pennington, H. (1997) *'Plea for Innocence to be Proclaimed'*, *The Times*, 28/1/97.

57 Fishman, L.J. (1993), *supra*, note 6, at 165 and Currie, C. (1996), *'Civil Enforcement as a Regulatory Device: The Use of the Civil Law as a Means of Enforcing Securities Law Violations'*, *Company Lawyer*, Vol. 17, No. 5, at 146.

58 For the benefits associated with administrative laws, see Lee, H.C. (1993), *supra*, note 47, at 125.

59 *Post*, chapter six.

60 *Company Investigations, Third Report, Trade and Industry Committee, House of Commons 36 Session 1989/90*, paragraph 602, at 121.

investigated it seems that these are, on the whole, dealt with by the *Authority* and *DTI* rather than by this unit. Over the years⁶¹ the unit has been subjected to a barrage of criticism, some of which may be seen to be unfounded, relating to the resources it has had at its disposal to deal with insider activities. Originally, any investigations were carried out manually.⁶² This position has now changed and the unit harnesses not only a general database that records the details of every transaction from the time of ‘*Big Bang*’ but also a real-time artificial intelligence programme that actively seeks and predicts possible insider activities.⁶³

As with most other bodies that deal with insider dealing investigations, the *International Stock Exchange* has a common policy of non-disclosure of information relating to an investigation where no evidence is found. However, in an effort to increase its effectiveness the Stock Exchange has pressed the Government for the right to publish its findings relating to enquiries so as to side step the failure created by criminal prosecutions.⁶⁴ It will also have a number of other beneficial effects. Executives who have initially been implicated will be publicly exonerated;⁶⁵ a fact that may increase voluntary co-operation.⁶⁶

⁶¹ Surveillance facilities were originally set up in 1974; Rider, B.A.K. (1983), *Insider Trading*, London: Jordans, at 148.

⁶² Although it has been noted that:

“from its early days...[the Stock Exchange] considered complaints from clients against their members and enforced the same high standards as it did in dealings between members.”

; Morgan, E.V. and Thomas, W.A. (1969), *The Stock Exchange: Its History and Functions*, London: Elek Books, at 166 *et seq.*

⁶³ Donovan, P. (1996), ‘*Insider Dealing Faces ‘Clean Up’*’, *The Guardian*, 30/1/96; ‘*Exchange Plans to Deter Insider Traders*’, *The Independent*, 31/1/96; Atkinson, D. (1997), ‘*Man vs. Bruin is No Contest*’, *The Guardian*, 21/3/97; Eisenhammer, I. (1996), ‘*Exchange Lobbies for Changes that would Introduce Fuzzy Software Spy*’. *The Independent*, 21/5/96 and Gapper, J. (1996), ‘*Stock Exchange Steps Up Insider Dealing Offensive*’, *The Financial Times*, 20/5/96.

⁶⁴ Donovan, P. (1996), ‘*Insider Dealing faces ‘Clean Up’*’, *The Guardian*, 30/1/96 and Tehan, E. (1996), ‘*SE Looks at Insider Policy*’, *The Times*, 31/1/96.

⁶⁵ *The Guardian*, 23/9/96.

⁶⁶ Rider, B.A.K. (1983), *supra*, note 61, at 153 *et seq.*

The *Stock Exchange* surveillance unit has always focused its attention on detection rather than prosecution.⁶⁷ Consequently, if it seems likely that enough evidence can be gathered in order for a criminal prosecution to be initially prepared for them, then all the evidence gathered is passed over to the *DTI*, which has more extensive powers of enquiry.⁶⁸

The *Stock Exchange* can be seen to adopt a positive policy of harnessing good relations not only between other investigating bodies in this country but also those from other jurisdictions. Thus, it has forged links with the United States and Canada, for instance, in a bid to combat those who wish to frustrate any detection by using an extra-territorial element in their activities.⁶⁹

Although both these bodies possess powers that relate to the investigation⁷⁰ or prosecution of these types of offences they rarely utilise them to full effect. It is feasible that this is due to their belief that securities frauds are largely regulatory offences.⁷¹ However, they cannot be dismissed out of hand as each can be called into play. Recently, the *Authority*, amongst other things, has implemented a *Shared Intelligence Service* designed to improve the efficiency of all *Authority* regulators by enabling them to bring together information in their possession that may facilitate any investigation underway.⁷² The *SFO*⁷³ is only brought in on a case if it fulfils the

67 Although it has prosecuted cases on those occasions when the *DTI* has referred a case originally investigated by the *Stock Exchange* surveillance unit back to them; see, for example, *R v. Lukins*, unreported but see *The Financial Times*, 8/11/90.

68 One of the underlying reasons behind this passing over was due to insider dealing becoming a criminal offence; see *post*, chapter three.

69 *Post*, chapter seven.

70 For example the *FSA* can carry out under an investigation under sections 94 and 105 *FSA* '86. For more details on the various sanctions available; see *infra*.

71 It is well established that both the *FSA* and *SFO* view insider dealing as a purely regulatory offence; Long, J. (1994), 'Policing the Markets', *Company Lawyer*, Vol. 15, at 83; and 'The Power of Fear', (1993) *Company Lawyer*, Vol. 14, No. 1, at 2.

72 *Securities and Futures Authority Annual Report*, (1993), at 18; the *Securities and Investment Board Annual Report*, (1992/93), at 30; the *Large Report*, 'Making the Two Tier System Work', (1993), at 58 *et seq.*; *The Regulation of the United Kingdom's Equity Markets - Discussion Document*, (1994), at chapter eight; *Securities and Investment Board Annual Report* (1993/94),

criteria of being classed as a ‘*serious and complex*’ fraud.⁷⁴ Although its general ambivalence towards securities frauds and insider dealing in particular casts doubt on whether these criteria are genuine or used as a convenient excuse.

The *DTI* has for a considerable time been bestowed with a variety of wide reaching powers of investigation into company affairs. Its powers allow it to inspect a company’s books and papers.⁷⁵ On paper, these are a useful means of curbing misfeasance and oppression. However, in practice they have not proved so effective.

Historically, the powers of investigating insider dealing and market manipulation have been either inadequate or non-existent.⁷⁶ This was partially due to the lack of importance that was originally placed on investigating these sorts of practices by regulating agencies.⁷⁷ However, under the *FSA* ’86 new powers of investigating have been developed. With regard to insider dealing it can be observed that it was not until 1980 that specific powers of investigation⁷⁸ came into force.⁷⁹

at 23 *et seq.*; *Securities and Investment Board Annual Report*, (1994/95), at 26 *et seq.* and *Securities and Investment Board Annual Report*, (1995/96), at 25 *et seq.*

⁷³ See *post*, chapter six specifically for more detail.

⁷⁴ *The Serious Fraud Office*, 1st Annual Report, at paragraph 11 *cf.* Staple, G. (1996), ‘*The Investigation and Prosecution of Serious Fraud: The Serious Fraud Office*’, March, *Journal of International Business and Finance Law*, at 107.

⁷⁵ *Third Report, House of Commons Trade and Industry Committee on Company Investigations* (1990), *supra*, note 19, at 36.

⁷⁶ *Post*, chapter one.

⁷⁷ *House of Commons Trade and Industry Committee Report on Company Investigations*, (1990), *supra*, note 19, at paragraph 166.

⁷⁸ ‘... The immediate purpose of most investigations is to find out what has happened or is happening when there are grounds to suggest some irregularity in the conduct of a company, businesses or individual in order to provide the Secretary of State with the information needed to decide what is to be done. A statutory investigation is only undertaken when other methods are inadequate to deal with the position, and the situation in itself sufficiently material or potentially of sufficient concern to warrant further investigation using the compulsory powers available. The ultimate purpose of any investigation is to provide information on which to take some action if the facts discovered in the course of the investigation warrant it...’

; *DTI Investigations Handbook*, April (1990), London: HMSO, at 3.

Indeed, pre – 1986 comparatively few statutory powers of investigation existed. It was not until section 177 *FSA* '86 was enacted in 1986 that the need to appoint inspectors was fully recognised.⁸⁰ Under section 177 important new powers were introduced whereby the Secretary of State could appoint inspectors⁸¹ to establish whether or not there had been a contravention of the legislation that dealt with insider dealing.

If it is suspected that a company has been engaged in insider dealing or market manipulation activities the *DTI* can appoint by virtue of the Secretary of State one or

79 “... We have dropped the special power to appoint inspectors to investigate suspected cases of insider dealing. We do not think that it is right to provide such far reaching powers that can threaten individual rights. If such powers are not generally needed for the investigation of crime, they should not be needed in this area... We took the view that, in practice we could obtain the information that is needed using existing officials and using *The Stock Exchange* mechanisms. Our proposal to get rid of investigators could make it easier to obtain the information we want...”

; *Commons Parliamentary Debates*, 1979/80, 1 Standing Committee ‘A’, at column 559 *et seq.*; *cf Commons Parliamentary Debates*, 20/3/86, Standing Committee ‘E’, at column 880:

“... The main reason for the small number of prosecutions and convictions has been the difficulty of obtaining sufficient evidence to prove beyond reasonable doubt...”

80 The provision came into effect on the 15/11/86 two months ahead of schedule and the main body of the *FSA* '86. This was due to the *Collier* investigation at the time; *see generally* Tridimas, T. (1989), ‘*The Financial Services Act and the Detection of Insider Dealing*’, *Company Lawyer*, Vol. 8, No. 4, at 162. Hannigan, B. (1994), *supra*, note 38, at 33, has made an interesting observation that since 1987 both the prosecution rates and number of inspectors appointed has fallen. She believes that this can be put down to the following factors:

- ‘(i) growing disenchantment with the legislation as prosecutions fail;
- (ii) a fall-off in insider opportunities as the economy went into recession;
- (iii) a change in culture in the City which has deterred would be insider dealers; or
- (iv) it may be that having watched a number of naïve individuals being prosecuted, the professional insider dealers have taken even greater care in hiding their tracks.’

81 *See generally*, *Investigation Handbook* (1990), *supra*, note 78, at appendix c. The appointment of inspectors has always attracted criticism. The Trade and Industry Committee noted that on average it took between 5 and 20 months to appoint inspectors after a referral, a delay which could result in the evidential trail going cold; *House of Commons Trade and Industry Committee Report on Company Investigations* (1990), *supra*, note 19, at paragraph’s 23-24. Consequently, its recommendations that the *DTI* decide within 21 days either to appoint inspectors or allow the stock exchange to prosecute received semi-positive response from the Government; *op cit.*, at paragraph 168.

more (although it is usually two) inspectors to delve into that company's affairs.⁸² Many of the appointments made usually come about because of a failure to produce documentation requested from an earlier investigation.

⁸² Section 432(2) *Companies Act 1985*.

5.3. *The Process of Enforcement in the United States*

In a similar manner to the United Kingdom with all *SRO*'s being answerable to the *Authority*, all exchanges in the United States must be registered with the *SEC*; this being achieved only through exchanges being able to show that they have adequate enforcement procedures in place that can be used against any member.⁸³

Monitoring, information gathering and investigatory powers are all initially carried out by exchanges and the *National Association of Securities Dealers*, who all have similar rules or practices needed to regulate their members. Likewise, the exchanges⁸⁴ as well as the *SEC*⁸⁵ possess extensive disciplinary powers that can be used at any time against member firms. The *SEC* also has supervisory rights over exchange disciplinary proceedings;⁸⁶ the reasoning behind this being that the threat of using the *SEC* to intervene into the affairs of exchanges makes the exchanges more diligent in their functions.⁸⁷

Established in 1934, the *SEC* can be viewed as the body most central in dealing with insider dealing and market manipulative practices and has generally been far more successful in its approach to these types of offences than the United Kingdom. This can put down to a number of significant factors. Firstly, its reputation and recognition as an elite body has drawn a large number of '*high flyers*', eager to gain from the experience of being associated with it, into its fold. Rather than being seen as a permanent career move many of those employed in the *SEC* only stay for a limited period, gaining valuable experience, before moving on into private practice. Other reasons that account for the *SEC*'s effectiveness relate to combining its extensive powers to increase the chances of prosecution with good co-ordination

83 Sections 6b *SEA* cf. Schedule 2 *FSA* '86.

84 Sections 6 and 15A *EA*.

85 Sections 15(b)(4) and (6) *EA*.

86 Section 19 *EA*.

87 Miller, R. (1985), '*Self-Regulation of the Securities Markets: A Critical Examination*', *George Washington and Lee Law Review*, Vol. 42, at 853 *et seq.*

between criminal agencies and itself. Although the *SEC* possesses a wide and varied arsenal of powers, which include administrative, cease and desist, and civil actions against securities perpetrators, it must refer any matters relating to criminal actions to the *Department of Justice* for scrutiny and action.⁸⁸ The reasoning behind this is because criminal investigations are viewed by the *SEC* as not being cost-efficient enough due to the complexities often associated with them. Hence, most *SEC* actions seek civil remedies.⁸⁹ The *SEC*'s licensing powers also provide an effective enforcement mechanism.⁹⁰ Under its licensing authority, the *SEC* can hold administrative hearings of a disciplinary nature.⁹¹

Investigatory and enforcement duties are primarily the responsibility of the regional offices of the *SEC*, which are located throughout the United States. Regional offices activities are subject to review and direction by the *SEC*'s Division of Enforcement. When the *SEC* learns of possible violations of federal securities laws, it commences a preliminary investigation. This involves a general request for documents and factual information.⁹² No subpoenas are issued, nor testimony compelled. The preliminary investigation is based upon the voluntary co-operation of the company or individual.⁹³ If the staff is dissatisfied with the results of the informal

88 Section 21(d) *SEA*.

89 Hazen, N. (1979), '*Administrative Enforcement: An Evaluation of the Securities and Exchange Commission's Use of Injunctions and Other Enforcement Methods*', *Hastings Law Journal*, Vol. 31, at 435 *et seq.*

90 Under section 6 *SEA*, the *SEC* can suspend or revoke registration of an exchange. Additionally, the *SEC* can also expel individual broker-dealers from a national exchange, can bar an individual from associating with broker-dealers and has powers dealing with the securities listed on an exchange; Hazen, N. (1979), *op cit.*, at 435 *et seq.* Under section 8 *SA* the *SEC* can delay, suspend, or stop the effective date of a registration statement, which is required before a new issue of securities can be sold to the public.

91 Matthews, R. (1980), '*Litigation in Settlement of SEC Administrative Enforcement Proceedings*', *Catholic University Law Review*, Vol. 29, at 235 *et seq.*

92 Note that broker-dealers must keep extensive records and file regular reports on their financial condition and keep accurate records of their transactions; section 17(a) *SA*.

93 Ferrara, D. and Nerkle, N. (1985), '*Overview of an SEC Enforcement Action*', *Corporate Law Review*, Vol. 8, at 306.

investigation, it may request the *SEC* to authorise named members of the staff to act as officials in conducting a formal investigation.

A formal investigation can be commenced once the *SEC* has found a likelihood of wrongdoing or that a person has violated or may have violated one of the securities statutes. The agency will issue an order of investigation to provide the staff with subpoena power.⁹⁴ At this point, the *SEC* can issue a judicially enforceable subpoena for the production of documents. In addition to gathering information, another preliminary remedial step, a trading suspension of a listed company, can be imposed at any time in the course of investigation. Unlike other federal agencies or the *Authority*, the *SEC* does not utilise special agents, whose assignments are limited solely to criminal investigations or to the matter under investigation. Attorney accountants and investigators are part of the permanent staff of the *SEC* and have a fact-finding role.⁹⁵ This approach enables the building of a cumulative expertise in securities regulation and enforcement.

Enquiries and complaints by investors are one of the primary sources of leads for detection of securities law violations. The regional offices also conduct surprise investigations of the books and records of brokers and dealers to determine whether their business practices conform to prescribed rules. They work closely with the exchanges and also trace market fluctuations in particular stocks.

The *SEC* has a spectrum of remedies at hand. The mildest remedial action is a cautionary letter, whereby the *SEC* staff may advise the corporation or individual of perceived violations of the securities laws or of conditions that makes violations likely. The cautionary letter is non-public. The most common enforcement remedy is the consent decree. The accused securities law violator agrees to refrain from a particular action in the future, does not admit wrongdoing, and agrees to pay a fine. A consent decree is efficient, effective and swift. Expense time and resource consuming

94 Section 21(b) *SA*.

95 Matthews, I. (1971), '*Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*', *George Washington Law Review*, Vol. 39, at 913 *et seq.*.

litigation is avoided. It is advantageous to the accused in that the company or individual can put the violations behind them.

One of the most effective and least expensive *SEC* enforcement activities is publicity. Under section 21(a) *SEA* the *SEC* can publicise the results of investigations by publicly naming individuals or issuing a public report of its investigation of *EA* violations. However, it can be noted that this device has been little utilised.

Under each of the *Securities Acts*, the *SEC* can seek temporary or permanent injunctive relief whenever it shall appear that any person is engaged, has engaged or is about to engage in a violation of securities acts. The *SEC* must show there is a reasonable likelihood of future violations. The injunction has been the *SEC* primary civil remedy and directs the subject to comply with the law in the future. The advantage of the injunction is the ease and speed with which it may be obtained and the civil burden of proof that is lower than with a criminal prosecution. An injunction can also aid private rights of action related to the same matter, because many courts have found that defendants are collaterally estopped from re-litigating matters determined in an injunction proceeding.

Associated with the *SEC*'s seeking injunctive relief, the equitable powers of federal district courts can give a range of relief ancillary to the statutory injunction. The purpose of ancillary relief is to provide individual remedies to meet the needs of a specific case and to ensure future compliance with the federal securities laws.

A *SEC* enforcement tool with an even lower burden of proof than an injunction is a section 15(c)(4) administrative action. Under section 15(c)(4) of the *EA* the *SEC* need only find for failure to comply in any material respect with one of the enumerated provisions, rules, or regulations under which the violations have occurred. Section 15(c)(4) has provided the *SEC* with a versatile remedy for reporting violations and reducing future non-compliance. It offers flexibility in dealing in administrative enforcement actions with accounting and complex issues. The *SEC* can specify under what standards or guidelines it may impose compliance and the time limits within which the issuer must fulfil ordered obligations.

The *SEC* can also seek in a federal district court, civil monetary penalties for violations of the *Securities Acts*, the rules and regulations thereunder, or cease and desist orders under the *Securities Enforcement Remedies and Penny Stock Reform Act 1990* (the '*PSRA*'). The statute creates three tiers of penalties based on the gravity of harm or threat of such by the violation. These sanctions are in addition to other actions that can be brought by the *SEC* or by the Attorney-General. The statute also permits the *SEC* to hold administrative proceedings against brokers/dealers, investment advisors, government securities dealers and other securities professionals that can result in monetary penalties and order for accounting or disgorgement of gains.

The *SEC* can obtain, after notice and a hearing, temporary and permanent cease and desist orders against individuals required to be registered with it and temporary cease and desist orders against regulated entities and associated persons. Cease and desist orders are essentially less severe penalties than injunction, more appropriate to isolated infractions without the collateral consequences of an injunction. The *PSRA* also allows the *SEC* to bar or suspend person from serving as an officer or director.

Alternatively, or in addition to civil relief, if the facts developed in a *SEC* investigation so warrant, the matter can be turned over to the United States Department of Justice, which works with the *SEC* in preparation of criminal charges. The *Justice Department* and the *SEC* may avail themselves of the additional investigatory resources of the *Federal Bureau of Investigation*. There may be parallel civil and criminal proceedings.

While the *SEC* staff itself conducts all administrative and civil litigation, the *Department of Justice* has sole jurisdiction over the conduct of criminal prosecutions. Regional United States attorneys, actively assisted by *SEC* staff members, present the *SEC*'s cases to grand juries, conduct trials, and brief and argue appeals.

In the 1980's *SEC* enforcement priorities turned to the prosecution of insider trading which had always been a concern. The *SEC* has used its whole arsenal of remedies to deal with insider trading. Usually, an administrative proceeding or

consent decree resulted in the disgorgement of gains. Criminal prosecutions utilised rule 10b-5 to regulate and enforce insider trading activity.

Congress concluded that the *SEC*'s traditional remedies, particularly the civil ones, were inadequate to deter insider trading. Its response was the *Insider Trading Sanctions Act of 1984* ('*ITSA*'), which gave the *SEC* authority to impose against insider trading violations a civil penalty for up to three times the profit gained or loss avoided from unlawful trading. The maximum fine for criminal violations was increased from \$10,000 to \$100,000. Unexpectedly, the *ITSA* was followed by a dramatic increase of insider trading cases involving prominent individuals and firms. Congress answered with the *Insider Trading and Securities Fraud Enforcement Act of 1988* ('*ITSFEA*'), which introduced new penalties for 'controlling persons' including employers who failed to take appropriate action once aware of, or in reckless disregard of, circumstances indicating that an employee was engaged in insider dealing. The *ITSFEA* created an affirmative duty for broker/dealers and investment advisers to establish, maintain, enforce, review, and update written policies and procedures reasonably designed to prevent insider trading.

A bounty programme was instituted whereby the *SEC* can pay informers up to 10% of the penalty imposed. The *EA* also codifies a private right of action for those who trade contemporaneously with and on the other side of the market with insider traders. This legislation will not stop an insider dealing, but by placing an affirmative burden on firms to monitor their employees or be subject to severe penalties and by encouraging potential witnesses and investigators through the bounty programme, it raised the stakes of engaging in such conduct. Such determination to deal with these illegal dealing practices is not yet evident in the United Kingdom.

Perhaps the greatest difference in regulatory approaches between the United Kingdom and the United States is the impact of the private right of action on securities enforcement. The *FSA '86* provides for a private cause of action by individuals who suffer loss as a result of security laws violations or a contravention of the rules of the organisation of which it is a member. Violators of the core conduct of business rules of the *Authority's* enforcement powers are subject to civil suit. The grant of a private right of action was the most controversial single provision in this

statute. Although under the *Companies Act 1989* amendments, the right to bring suit under the *FSA '86* has been limited to investing members of the public in the United Kingdom, a notably non-litigious group.

In the United States investors' private rights of action complement government enforcement of securities laws. While American securities laws provide some express remedies, courts have found that Congress intended to give private parties implied rights of action for violations of many sections of the securities laws. Because of the ambiguities in the legislative history of the American Securities Acts, whether private plaintiffs have a right of action for violation of a particular section of the securities acts has been a subject of ongoing judicial interpretation. The lower courts were particularly responsive to the expansion of private rights of action, and this has had a multiplier effect upon the overall enforcement effort.

Though rights of action for damages are more explicit in the *FSA '86*, it is doubtful that private litigation will play nearly as important a role in the English system given the limitations on contingent fees for lawyers and the weight of interest groups against private rights of action.

5.4. *Following the American Way: The Impact of the Financial Services and Markets Bill on Regulatory Enforcement*⁹⁶

Given that there is no one true financial centre that exists in today's market place the strength of the United Kingdom economy largely depends on the fairness and dependability of its financial markets. These two facets are largely dependent on the activities carried out by the *Authority*. However, recently two substantial proposals have been put forward in the *Financial Services and Markets Bill* which, when implemented, will radically shape what will become '*market abuse*', that is any activity that attacks the two principles already mentioned. Whether or not this *Bill* achieves its desired affect when it actually becomes law is debatable given that a large number of criticisms have already been made of it. This section examines what amounts to market abuse and looks at the new sanctioning powers that have been put forward to enforce against such a practice. It also examines the criticisms made of the *Bill* to assess whether or not they will make the present regulatory system more resistant to market abuse or whether it just provides a '*broad brush*' regulatory approach that will ensnare innovative, but not technically illegal market practices.⁹⁷

The two main proposals made clear in the *Bill* deal with what amounts to market abuse and when this will attract a civil liability. A *Code* has also been provided. This deals with what amounts to market conduct.⁹⁸

Under clause 56 of the *Bill* market abuse is viewed as behaviour in relation to qualifying investments, traded on markets designated by the Treasury, which satisfies at least one of the following tests:

⁹⁶ Note: A more detailed account of the *Bill* can be found in the appendix.

⁹⁷ See generally Freshfields - '*FSA: Market Abuse*', (1998), Practical Law for Companies, Vol. 9, No. 7, at 77 *et seq.*; Alcock, A. (1998), '*The Draft Financial Services and Markets Bill*', Company Lawyer, Vol. 19, No. 9, at 258 *et seq.* and Clarke, M. and Hunter, G. (1999), '*Combating Financial Crime*', European Counsel Supplement, Vol. 4, No. 8, at 43 *et seq.*

⁹⁸ '*Draft Code of Market Conduct Proposed*', (1998) Financial Services Bulletin, Vol. 6, at 1 *et seq.* and Nelson, E. (1998), '*The FSA's Code of Market Conduct*', Compliance Monitor, Vol. 11, No. 2, at 21 *et seq.*

- (i) a distortion test (relating to behaviour that is likely to distort the market)
- (ii) a misleading impression test (relating to behaviour that gives market participants the wrong impression regarding value, supply, demand or price);
or
- (iii) a privileged information test (which relates to information that is not available to market participants which if known would have a bearing on whether any transaction was entered into).

Under clause 57 of the *Bill* the *Authority* must publish a code for the purpose of helping to determine whether or not behaviour amounts to market abuse. It is intended that breach of the code be evident of breach of the prohibition on market abuse. If the *Authority* is satisfied that a person has engaged in market abuse, it may impose a fine on him, seek an injunction from the court or order him to disgorge profits. The operation of these provisions will not be limited to persons who are authorised to carry on regulated financial sector business; the *Authority* will have unlimited jurisdiction over anyone whom it considers to have committed market abuse. Authorised persons will also be subject to the disciplinary powers of the *Authority*, which can lead to public censure or loss of authorisation as well as the remedies already mentioned. The *Authority* alone will determine the procedures leading to any of these outcomes, except in relation to proceedings for an injunction, which will be in the usual situation of acting as investigator, prosecutor and tribunal in each case.⁹⁹

The introduction of a new market offence is all well and good in deterring unfair behaviour but it should be noted that various provisions already exist that deal with market abuse. The proposals in the *Bill* therefore provide yet another layer of potential liability and consequently there is a real danger of greater complexity being generated unless this position is clarified. The new regime seeks to extend rules currently applicable only in organised markets in two ways:

⁹⁹ 'FSA: New Powers to Combat Market Abuse', (1998) *International Banking and Finance Law*, Vol. 17, No. 2, at 13 *et seq.* and Elgar, J. and Shaxson, F. (1998), 'New Powers to Tackle Market Abuses', 10 *Corporate Counsel*, Vol. 10, at 52.

- (i) Under the *Bill*, the Treasury would have power to specify which markets are covered by the new regime. This power is not restricted to organised markets but may also be exercised to bring OTC markets within the scope of these new arrangements for tackling market abuse.
- (ii) The jurisdiction of the *Authority* to impose civil fines would not be confined to conduct by members of the exchanges. Market abuse perpetrated in the OTC look-alike or back-to-back markets in investments traded on those exchanges designed by the Treasury would also be caught under the new regime where the conduct was aimed at manipulating exchange-based markets or taking unfair advantage of information relating to investments traded on those markets. This issue, in turn, may cause problems in that many exotic options negotiated on a bespoke basis may be put together and largely executed outside the United Kingdom for fear of being innocently implicated.

Every exchanges has its own disciplinary procedures however given that the *Bill* also contains procedures that may cause an overlap between firms regulations and statutory procedures this potentially causes problems in that many firms will find themselves in the precarious position of double jeopardy.

In relation to the abuse of privileged information, the new legislation overlaps with the insider dealing regime and the *Take-over Code*, potentially exposing market participants to criminal proceedings or, in the case of takeover advisers, discipline by the Takeover Panel as well as the *Authority* for the same conduct.

Conduct that is currently criminal under the *Criminal Justice Act 1993* would also fall foul of the proposed regime under the *Code*. The proposed new regime is, however, wider than the current insider dealing regime set out in the *Criminal Justice Act 1993* in a number of important way s:

- (i) The Code does not follow the definition of inside information as set out in the *Criminal Justice Act 1993*. To satisfy the current test, the information must relate to a specific issue or issues of securities, must

be specific or precise, and if made public, must be such as would have a significant effect on the price of the securities. The *Code's* definition of '*relevant information*' is any information that a market user would reasonably regard as significant in determining whether or not to deal in an investment. It will not be necessary to establish whether publication of the information would have had a significant effect on the price in question.

- (ii) At present only individuals can be prosecuted - under the new regime corporates and other organisations could be fined for the actions of their employees and have other action taken against them.
- (iii) Since June 1996 it has been obligatory under the Takeover Code for take-over bidders to disclose details of derivatives positions held which relate to securities in the target company. This captures (amongst other take-over-related activity) take-over bidders implementing a hedging strategy to cover themselves against price movements in case their bid fails. The new regime would only allow the bidder to buy the shares of the target, completely disallowing any strategy to obtain any other economic exposure to price movements in the shares.
- (iv) The current regime requires some sort of relationship between the insider and an issuer employment. In the proposed new regime, the relevant concept is '*privileged possession*': the only question is whether the person with the information knows that other market users cannot legitimately obtain that information. Somebody who invents a clever new tool for analysing performance of securities could thus be in '*privileged possession*' and be open to attack under the *code*.
- (v) These provisions seem designed to widen the range of conduct that is currently on the fringes of insider dealing in order to bring them within the scope of the new disciplinary regime. Increasingly market users would have to seek legal advice as to the propriety of proposed trading

strategies in order to avoid the risks of ‘*civil fines*’ or the other sanctions available to the *Authority* under the *Bill*.

Given the overlap between the *Authority*’s enforcement powers in respect of the *Code* and the existing responsibilities of the *DTI*, *Serious Fraud Office*, exchanges and the *Takeover Panel*, the *Authority* suggests that relevant organizations will need to work closely to avoid duplication. The results of this may not necessarily build on existing enforcement experience or lead to the most appropriate enforcement body dealing with the relevant cases. Rather, it could lead to unhelpful competition between regulators.

Generally, the degree of overlap between the proposed new regime under the *Bill* and *Code* seems to fly in the face of the belief that there should be a consolidation of agencies and tiers of law and regulation which are intended to deter unacceptable behaviour and, where necessary, take action against it.

By using examples of market abuse and in refraining from proposing a comprehensive definition, the *Authority* has clearly accepted that market abuse is a difficult concept to define. However, clear and precise definitions of transactions that constitute market abuse are equally elusive. In the broadest sense, all trading has a tendency to make prices move and therefore ‘*normal*’ trading needs to be excluded. In the narrowest sense, deliberately releasing false information into the market to change the price of an investment is clearly market abuse. The types of transaction in between are extremely varied and are constantly in flux.

The *Code* tackles this dilemma by broad drafting of the types of transaction that constitute market manipulation and misuse of information; by not requiring abusive intentions on the part of the wrongdoer. The *Code* potentially catches all transactions in between the two extremes and, most alarmingly, common transactions which are currently permitted and generally regarded as ‘*safe*’.. The *Authority* attempts to set out guidance as to potential categories of carve-outs, but such guidance is very limited.

Under the current framework, market supervisors and the competent authority are viewed as best placed to regulate market conduct. This approach is in marked contrast to those views put forward in the Consultation Paper where the *Authority* alone is to define whether market conduct should be classed as abuse. However, exchanges are closest to the marketplace and are keenly aware of the fine line dividing acceptable market practice and market abuse. They therefore would seem to be the most appropriate persons to formulate rules on market conduct.

While rules are certainly needed to ensure that all significant market players comply with standards of good behaviour, there is no obvious need to apply a regime of civil fines to all market users. It will very quickly run into cross-border jurisdictional difficulties and, without a concerted effort by regulators in different countries to take the same approach, will very quickly succeed in doing one of two things: driving some internationally mobile business out of the United Kingdom's financial markets, or showing that the *Authority* cannot deliver penalties under the new market abuse regime.

Even where the existing regulatory arrangements allow unsuitable conduct to go unchallenged, there is the criminal law. Shortcomings in the criminal legal system where financial-sector activity is concerned have received much attention in the press. To solve these difficulties by a regime that allows for penal sanctions to be imposed by the *Authority*, acting as a non-judicial body, potentially behind closed doors without a hearing and without legal representation for the '*accused*', seems rather extreme. A middle way ought to be achievable in the interests of financial markets based in the United Kingdom.

5.5 Summary

As observed in the chapter both the United Kingdom and the United States have traditionally adopted radically opposing views and structures in the way they implement regulatory enforcement. Both systems can be perceived to contain advantages and disadvantages - the United Kingdom, for instance, being viewed as too fragmentary whilst the United States being viewed as slow to act against insider dealing. Yet, it seems that the system adopted and more importantly the ideological beliefs placed on enforcing insider trading and other trading abuses is radically different from that of the United Kingdom. One striking difference is the emphasis that is placed on providing new recruits with a '*spring board*' on which to launch their career. This does not and seems unlikely to materialise in the United Kingdom. Moreover, this is not the only striking difference. The stress that is placed on combating insider dealing in the United States is impressive. The implementation of new legislation on more than one occasion within a short space of time illustrates the importance the United States places on market regulation. However, can the same be said of the United Kingdom with the passing, in the near future, of the *Financial Services and Markets Bill*?

The *Financial Services and Markets Bill* is an extremely unstable piece of legislation at present. I use the word '*unstable*' mainly because many of the criticisms of it have yet to be settled. However, this is understandable given the stage the *Bill* is at. It is interesting to note the since this new piece of legislation has been presented many of the traditional problems which raised their head under the *FSA '86* have not yet been resolved. The fragmentary nature of the overall structure, the fact that '*turf battles*' will be evident at times and the issue of '*double jeopardy*' have all been discussed and criticised. So can this *Bill* be argued to improve the present, pre-implementation, period. Some would argue 'yes' as it seems that the place more emphasis on the notion of regulatory enforcement and as a by-product creates investor confidence in the market. Yet, on the other hand the fact that the market may be too regulated and consequently hinder its growth. Indeed, given the forecast that the markets that will grow the most in the future are those that are secondary can it be said that this *Bill* will take on-board the complex and innovative nature of some of

these financial instruments. At present there is no way of telling how the *Bill* will eventually appear as an *Act* but it is hoped that most of these issues will be resolved if only for the sake of financial growth.

Chapter Six

From Caught to Court: The Problems Associated with Prosecuting Financial Fraud and Sentencing Financial Criminals

Overview

In the United Kingdom the reliance on the criminal law and the criminal justice system to enforce it represents to many the achilles heel in bringing market fraudsters to account for their actions. Yet is this view wholly justified? The purpose of this chapter is to examine the main issues of contention surrounding the prosecution process generally to hypothesise whether the role of the criminal law and the sentencing of offenders can indeed be improved upon.

For the sake of clarity this chapter is divided into two sections. Section one identifies the fundamental problems associated with the prosecution of financial criminals and assesses the validity in these assumptions. Whilst section two turns to the issue of sentencing and examines the salient issues surrounding the most appropriate way to sentence market abusers.

6.1. Common Problems Associated with Fraud Trials

In any criminal trial, legal rules structure the proceedings and determine the amount and kinds of information, which are relevant. The arguments offered by both prosecutors and defendants alike are shaped by the requirements of rules relating to evidence and by the nature of the offence or offences themselves. Defendants, for example, cannot simply claim that offences were not their fault; they must provide legal arguments that deny any legal accountability. Not surprisingly, in trials involving financial crimes, the law itself and the specific characteristics of the offence strongly influence the tactics and strategies that are available to both types of counsel.

The task of the prosecution in any criminal offence is to present sufficient evidence to prove *beyond a reasonable doubt* that the defendant did commit the offence in question and that he had both the required *mens rea* and *actus reus* that coincided to form that offence. Yet, it is because of the need for such a high standard of proof that many offences fail to be prosecuted. Often this position is further exacerbated because of the unique characteristics attached to such financial crime trials. Many involve more than one defendant, each of who may have participated in only some of the activities and some of whom may be only indirectly implicated. Complex cases may also involve a number of different kinds of offences, all of which are the subject of different indictments, and some of which may be easier to prove than others. In addition, the evidence generated in these types of cases can involve mountains of documentation, detailed examination of corporate and personal banking transactions,¹ and require testimony of witnesses, some of whom may be unable or unwilling to testify may all contribute in making the trial last months rather than weeks.²

¹ Burns, I. (1997), 'The Paper Chase', Accountancy, Vol. 120, No. 1250, at 43 and Wright, I. (1999), 'Fraud and the Criminal Justice System: Part 2', February, Fraud Intelligence, Vol. 13, at 13 *et seq.*

² Levi, M. (1987), *Regulating Fraud: White Collar Crime and the Criminal Process*, London: Tavistock.

With length of time comes increased cost, as trials involving fraud are never cheap to bring. Nine years ago it was estimated that to bring an insider dealing prosecution it would cost in excess of £100,000. Today's figures will invariably be higher. Yet apart from the overall high expense, one of the most fundamental areas that have been contested in recent years is the right for these types of trial to be tried by jury.³

The jury system was said to be imported to the United Kingdom⁴ after the Norman Conquest⁵ to provide a number of functions. They acted as witnesses, providing information about local matters, and were largely used in administrative matters. However, by the time of *Henry II*, the jury began to take on an important judicial function, moving from reporting on events they knew about, to deliberating on evidence produced by the parties involved in a dispute. Gradually it became accepted that a juror should know as little as possible about the facts of the case before the trial, a trait still carried on today. A major milestone in the history of the jury was in the case of *Bushell*.⁶ Before this, judges would try to bully juries into convicting the defendant, particularly where the crime had political overtones, but in *Bushell's case* it was established that the jury were the sole judges of fact, with the right to give a verdict according to their conscience, and could not be penalised for taking a view of the facts opposed to that of the judge. The importance of this now is that juries have the independent capacity to acquit a defendant, without being pressurised by a judge.

3 'Time, Money and the Jury', (1995) 145(6715) New Law Journal, at 1493; Wright, T. (1998), 'Prosecution White Collar Crime – What's Going On?', November, *Amicus Curiae*, Vol. 12 at 12 *et seq.*; McKenna, M. (1998), 'Juries in Serious Fraud Trials', July/August, *In-House Lawyer*, Vol. 62, at 77 *et seq.*; Hansen, I. (1998), 'Juries in Serious Fraud Trials', June, *Amicus Curiae*, Vol. 8, at 4 *et seq.*; 'Juries and Fraud Trials', (1998), April, *Criminal Law Bulletin*, Vol. 32, at 7 *et seq.*; Rhodes, N. (1998), 'Juries in Fraud Trials', New Law Journal, Vol. 148, No. 6828, at 239 *et seq.* and 'Here We Go Again...and Again', (1996), New Law Journal, Vol. 146, No. 6728, at 77. See also *Juries in Serious Fraud Trials – A Consultation Document*, Home Office, (1998).

4 Although the fact that it originated from the Holy Roman Empire is mere conjecture.

5 However, it should be noted that there are possible antecedents of the jury to be found in the *Laws of Aethelred* (997).

6 *Bushell's Case* [1670].

While the value of juries has very rarely been questioned in criminal trials the role it plays in cases involving financial crime has often been suspect.⁷ This is essentially down to the question of suitability - that is, can jurors be found that not only possess the ability to give up a large period of their time⁸ but also have the intellectual abilities needed to comprehend complex and detailed evidence often needed if a conviction is to be gained?⁹ It is therefore not surprising then that it has been suggested that the use of juries have become the scapegoat for the inherently risky nature associated with financial fraud trials¹⁰ and that by limiting the use of juries, using streamlined rules of evidence¹¹ and by the use of computerised transcript recording techniques¹² conviction ratings *may* increase.¹³

Prosecutions are rarely undertaken unless there is a reasonable chance of success. Therefore one would assume that it might be expected that cases would be watertight when they are prosecuted. In the United States, for example, prosecution

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- 7 'Time, Money and the Jury', (1995) 145(6715) New Law Journal, at 1493; Wright, T. (1998), 'Prosecution White Collar Crime – What's Going On?', November, *Amicus Curiae*, Vol. 12 at 12 *et seq.*; McKenna, M. (1998), 'Juries in Serious Fraud Trials', July/August, *In-House Lawyer*, Vol. 62, at 77 *et seq.*; Hansen, I. (1998), 'Juries in Serious Fraud Trials', June, *Amicus Curiae*, Vol. 8, at 4 *et seq.*; 'Juries and Fraud Trials', (1998), April, *Criminal Law Bulletin*, Vol. 32, at 7 *et seq.*; Rhodes, N. (1998), 'Juries in Fraud Trials', *New Law Journal*, Vol. 148, No. 6828, at 239 *et seq.* and 'Here We Go Again...and Again', (1996), *New Law Journal*, Vol. 146, No. 6728, at 77. See also *Juries in Serious Fraud Trials – A Consultation Document*, Home Office, (1998).
- 8 Levi, M. (1991), 'Sentencing White Collar Crime in the Dark?: Reflections on the Guinness Four', *Howard Journal*, Vol. 11, at 253 *et seq.*
- 9 Verkaik, P. (1996), 'In Search of the Better-Educated Juror', *The Independent*, 28/2/96 and Honess, T. (1998), 'Juror Competence in Processing Complex Information: Implications from a Simulation of the Maxwell Trial', November, *Criminal Law Review*, at 764 *et seq.*
- 10 Roberts, M. (1996), 'Trial by Jury Gets a Vote of Confidence', *Lawyer*, Vol. 10, No. 33, at 10 and Oliver, P. (1996), 'Verdict does not Affect Trial's Fairness', *Lawyer*, Vol. 10, No. 38, at 8.
- 11 Clarke, M. (1986), *Regulating the City: Competition, Scandal and Reform*, Milton Keynes: Open University, at 32 *et seq.*
- 12 Judge Stanley (1996), 'Fraud Trials after Maxwell', September /October, *Counsel*, at 20 *et seq.*
- 13 Clarke, M. (1998), 'Fraud, Prosecution and Regulation: Achieving Effective Control', *Journal of Financial Regulation and Compliance*, Vol. 6, No. 3, at 232 *et seq.*; Dickson, R. (1998), 'The Best Way Forward in Fraud Trials?', June, *Amicus Curiae*, Vol. 8, at 5 *et seq.* and Nove, T. (1999), 'Fraud Investigation and Prosecution - The Way Forward', *Journal of Financial Crime*, Vol. 6, No. 4, at 370 *et seq.*

follows intensive pre-trial review and negotiation between prosecution and defence attorneys. To defence attorneys, prosecution in itself represents failure, as their first aim is to prevent it.¹⁴ Where cases are taken to court therefore it is likely that there is strong evidence and defendants may secure some advantages by plea-bargaining. Therefore, few cases are contested.¹⁵ However, this does not mean that defendants cannot attempt to minimise their guilt by denying intent and culpability. Rather than use these arguments to contest guilt, they can be used in an attempt to reduce the sentence. Consequently, in fraud trials substantive legal arguments are often used not in defence, but in an adversarial sentencing process.¹⁶ Pleading guilty has the additional advantage that it reduces the amount of evidence provided by the prosecution, as they do not have to establish intent or *mens rea*. Therefore, evidence which might indicate dishonesty and blameworthiness is not provided, which enables defendants to deny their existence in mitigation.¹⁷ In the United Kingdom, where the powers of regulators to secure 'out of court settlements' and conduct pre-trial negotiations are very different, these considerations may not apply.¹⁸ Of more concern in England and Wales has been an apparently high rate of acquittals, often attributed to the inability of juries to comprehend proceedings.¹⁹ Whether or not acquittal rates are too high is impossible to judge in the absence of any standard that indicates how many acquittals can reasonably be expected, but it is clear that many acquittals result, not from jury decisions, but from judges' directions on legal

14 Mann, K. (1985), *Defending White-Collar Crime*, New Haven: Yale University Press, at 21 *et seq.*

15 Mann, K. (1985), *op cit.*, at 66 *et seq.*

16 Mann, K. (1985), *supra*, note 14, at 98.

17 Wheeler, S., Mann, K. and Sarat, A. (1988), *Sitting in Judgement: The Sentencing of White-Collar Criminals*, New Haven and London: Yale University Press, at 10 *et seq.*

18 Levi, M. (1987), *supra*, note 2 and 'Regulation Roadshow', Centre for the Study of Financial Innovation, (1999) 149(875) *Banker*, at 13.

19 Levi, M. (1983), 'Blaming the Jury: Frauds on Trial', *Journal of Law and Society*, Vol. 10, No. 2, at 258 *et seq.* and 'SFA Wants No-Jury Trials for Fraud', (1998) 8 *Financial Services Brief*, at 2 *et seq.*

technicalities, which may result from the prosecution's failure to provide sufficient evidence.²⁰

The prevalence of financial crimes in occupations and organisations where they are widely tolerated demonstrates the limited impact the criminal law has had in this area. Enforcement problems, the small number of prosecutions, and the leniency of sanctions further constrain the preventive and deterrent value of the criminal law. This is exacerbated by the many ambiguities and loopholes associated with specific laws. Few disagree that the law has a limited impact, but there are conflicting analyses of why this is the case and what should be done about it.

Broadly speaking three distinct approaches to these questions can be discerned. Following the logic of what might be called a '*regulatory*' approach; some argue that the criminal law should be used sparingly given the cost and ineffectiveness of prosecution. The nature of the activities to be regulated in any event create problems for law and its enforcement and, therefore, greater emphasis should be placed on self-regulation and administrative sanctions, which are cheaper and more effective, and thus better protect the public. A very different agenda is advocated by those who argue that the laws are weakened by their failure to treat the crimes of wealthy and powerful offenders with the same vigour applied to conventional offenders. White-collar crime, they argue is crime and *ought* to be dealt with as severely as other crimes. Accordingly, the criminal law should be strengthened, more offenders should be prosecuted and sanctions should be tougher.²¹

These views represent somewhat extreme positions, and elements of both can be combined. It can be accepted that self-regulation and administrative sanctions may well be more effective in preventing and even deterring offences, but also that they may not be sufficient. It can also be accepted that public prosecution and punishment are necessary on the grounds of morality and justice, as the offences are offences and

²⁰ Levi, M. (1987), *supra*, note 2, at 45 *et seq.*.

²¹ Pearce, F. and Tombs, S. (1990), '*Ideology, Hegemony and Empiricism: Compliance Theories and Regulation*', *British Journal of Criminology*, Vol. 30, No. 4, at 423 *et seq.* and Stronach, J. (1996), '*Serious Fraud: Civil or Criminal?*', January/ February, *Counsel*, at 12.

offenders do enjoy advantages. Sentencing policies should therefore aim at prevention and deterrence along with justice and equity. *Braithwaite*, for example, in his theory of re-integration shaming suggests a mixture of policies combining self-regulation and state punishment, which would shame offenders without stigmatising them, and provide for stiffer punishments to underline the moral unacceptability of offences.²²

The inability of criminal law to substantially reduce crime is not restricted to financial crime. It is now widely accepted that what are generally known as reductive sentencing policies, *that* aim to either deter or rehabilitate offenders, are relatively ineffective in preventing recidivism, and have little effect on the volume of crime as only a small minority of conventional offenders are ever caught and subjected to punishment.²³ Deterrent policies have other limitations. It has often been argued, for example, that the majority of the population do not commit crimes because they feel they are morally wrong, and tend to be more worried about the reactions of friends and family than about particular forms of punishment.²⁴ These kinds of arguments can be used in support of a '*just deserts*' model that justifies punishment on the grounds that offenders have done wrong and, therefore, '*deserve*' punishment. Sentences should be based on considerations of culpability and should be in proportion to the gravity or seriousness of the crime, thus ensuring equity and justice. In theory, this should eliminate the inequities and disparities often attributed to individualise sentencing based on rehabilitative considerations.²⁵

Recent proposals to reform sentencing policy indicate a shift away from rehabilitation and deterrence in favour of principles of just deserts, and in addition stress the importance of incapacitation, which may be necessary for public protection.

22 Braithwaite, J. (1989), *Crime, Shame and Re-Integration*, Cambridge: Cambridge University Press, at 75 *et seq.*

23 Ashworth, A. (1994) '*Criminal Justice and Deserved Sentences*', *Criminal Law Review*, at 341 *et seq.*

24 Braithwaite, J. (1989), *supra*, note 22, at 81.

25 Hudson, B. (1987) *Justice Through Punishment*, Basingstoke and London: Macmillan, at 64 *et seq.*

These kinds of proposals reflect a general consensus that prison should be used less, and should be reserved for the most serious, persistent, violent and dangerous offenders, however these might be defined. Current proposals also suggest that more emphasis should be placed on '*punishment*' in the community.²⁶ Crime reduction, on the other hand, is better achieved by strategies aimed at preventing crime, where more responsibility is placed on individual citizens to protect themselves.

These arguments have also affected analyses of white-collar crime, although the application of specific policies and proposals may be somewhat different. Many conventional crimes are unambiguously regarded as criminal and, therefore, few would dispute that burglars *should* be prosecuted or punished however ineffective this may be in reducing the total amount of burglary. The many differences between white-collar offences and offenders, and their conventional criminal counterparts also means that the application of principles of deterrence retribution, incapacitation and rehabilitation may be very different, especially in relation to organisational crime.²⁷

It is often assumed that a major aim of sentencing white-collar offenders is deterrence. This reflects a general view that offenders are more deterrable than others, as offences are assumed to be economically motivated and involve calculated risks by rational actors.²⁸ Defendants' arguments that the process is punishment also reflect the potential deterrent value of the law as many individual offenders do risk losing their employment and reputation, high incomes and comfortable life styles. Corporations are often assumed to be future orientated, concerned about their reputation and '*quintessentially rational*'.²⁹ Unfavourable publicity and the

²⁶ Vass, A. (1990), *Alternatives to Prison: Punishment, Custody and the Community*, London: Sage, at 167 *et seq.*

²⁷ Braithwaite, J. and Geis, G. (1982), '*On Theory and Action for Corporate Crime Control*', *Crime and Delinquency*, at 294 *et seq.*

²⁸ Braithwaite, J. and Geis, G. (1982), *op. cit.*, at 296.

²⁹ Braithwaite, J. and Geis, G. (1982), *supra*, note 27, at 297.

harrowing experience of investigation, prosecution and trial, therefore, can and do act as deterrent.³⁰

Nonetheless, this deterrent potential can be undermined by the low rates of detection and prosecution, and the limited impact of sentences. The view that offences arise from rational and conscious decision making can also be questioned particularly in relation to organisational crime where individuals may not intend to commit offences. The criminogenic elements of organisations may also remain whatever punishment follows conviction, thus effectively neutralising any deterrent effect.³¹ In addition, *Levi* argues that the '*fall from grace*' effect may be exaggerated.³² Some offenders may lose their occupational status, but may be able to pursue alternative careers and may even benefit indirectly from their offences. For example, many of the Watergate conspirators profited greatly from their memoirs! In other cases, offences may be a consequence of the failure or poor performance of a business; therefore, offenders have already lost everything anyway.

Whether or not deterrence works in practice, it can also be argued that it is not and should not be the only principle underlying the use of the criminal law or the sole aim of punishment. Proponents of a '*just desert*' approach, for example, argue that offenders should be publicly prosecuted and punished for their offences, and many object to the implicit inequity of treating one group of offenders differently from any other group. However, the '*just deserts*' approach also creates several problems, particularly in relation to financial crime.³³ '*Just deserts*' models rely on notions of guilt, blame and culpability, which could lead to less '*justice*' for financial criminals, given their ability to minimise elements of intent and culpability. In addition, to

30 *Levi, M. (1987), supra, note 2 at 89 et seq..*

31 *Moore, C.A. (1987), Taming the Giant Corporations? Some Cautionary Remarks on the Deterrability of Corporate Crime', Crime and Delinquency, Vol. 33, at 383 et seq..*

32 *Levi, M. (1987), supra, note 2, at 54 et seq..*

33 *Braithwaite, J. (1982), 'Challenging Just Desserts: Punishing White Collar Criminals', Journal of Criminal Law and Criminology, Vol. 73, No. 2, at 125 et seq. and Braithwaite, J. and Pettit, P. (1990), Not Just Deserts: A Republican Theory of Justice, Oxford: Clarendon Press, at 243 et seq..*

prosecute all financial crime offences, let alone all conventional offenders, would be prohibitively costly. Principles of just deserts further stress that punishment should reflect the harm done. However, it has been previously noted that offences are often considered to be less serious and therefore any equation of punishment to harm done might have little effect. A general problem with the implementation of just deserts models lies in the difficulties of determining which crimes are more serious than others, and whose definitions of seriousness are adopted. Application of '*just deserts*' models could well perpetuate class based and ideological definitions of the seriousness of crime, thus confirming the distinction between white collar crimes and '*real crimes*'.³⁴

³⁴ Hudson, B. (1987), *Justice through Punishment*, London: Macmillan, 5 *et seq.*.

6.2. *Sentencing the City Fraudster*

Generally speaking, there has been little discussion of the application of the principles of sentencing to market abuse. High profile offenders are rarely seen being in need of help, advice or counselling as they are assumed to have made rational choices when embarking on their crime. Therefore, rehabilitative policies have rarely been considered. Similarly, incapacitation is also rarely considered given that abusive market practices can be perceived as 'victimless', offenders are not likely to be defined as 'dangerous' and losing their jobs before conviction may have effectively incapacitated them. Consequently, they will not have the opportunity to become persistent offenders. However, it can be argued that incapacitation *can* be a useful approach as individual offenders can be disbarred or disqualified.³⁵

Yet whatever sentencing policies are adopted, their effect in reducing crime and thereby protecting the public may be limited. Thus, as is increasingly the case for conventional crimes, much emphasis is placed on public protection and prevention, which underlie the use of preventive and compliance strategies. The role of self-regulation is also of great significance, as ultimately more crime can be prevented within organisations themselves. Effective regulation may therefore, require both preventive policies and a range of different sentencing policies.³⁶

Braithwaite suggests such a combination in an attempt to develop an approach that can be applied to both conventional and white-collar crime.³⁷ Accepting that traditional sentencing policies and strategies of crime control have failed, he argues that the most effective social control exists where offenders experience shame for their actions and where there is strong moral disapproval of wrongdoing. Therefore, tough formal punishment should underline the moral unacceptability of offences and policies should encourage shaming. However, it is argued, that punishment should not be too severe, as this can create 'outcasts' and 'organised subcultures of

35 Braithwaite, J. and Geis, G. (1982), *supra*, note 27, at 299.

36 Nove, T. (1998), 'Closing the Loopholes', *Policing Today*, Vol. 4, No. 4, at 12 *et seq.*

37 Braithwaite, J. (1989), *supra*, note 22, at 97 *et seq.*

resistance'. Policies should, therefore, aim at support and re-integration rather than stigmatisation. For most kinds of white-collar crime, he argues:

*'...the moral educative functions of the law are sorely neglected by insufficient levels of formal punishment coupled with state shaming.'*³⁸

Punishment for organisational crime should therefore maximise the sense of shame which:

*'...communicates the message that white collar crime is as abhorrent to the community as crime in the streets.'*³⁹

Policies should, therefore, underline the moral unacceptability of white collar crime, by encouraging widespread publicity which would shame offenders along with firmer punishments where necessary. The closest approximation to the '*family model of punishment*' for white-collar crime is self-regulation within organisations, which should encourage moral disapproval for non-compliance. This, however, must be backed up by state punishment. Therefore, neither prosecution nor persuasive models best fit the requirement of re-integrative shaming - adversarial approaches threaten to make outcasts of otherwise compliant businesses and compliance strategies underplay the moral educative function of the criminal law. Effective business regulators he argues, are those who are flexible enough to persuade offenders who are willing to comply and at the same time use punishment against the recalcitrant.

Many strategies are suggested by these arguments. Some focus almost exclusively on prevention and protection of the public, leading to suggestions for increased self-regulation and even decriminalisation. Others wish to see the criminal law tightened and penalties made more severe, and yet others argue that new strategies should be developed which may be more appropriate to the specific problems posed by white-collar offences and offenders.

³⁸ Braithwaite, J. (1989), *op. cit.*, at 132.

³⁹ Braithwaite, J. (1989), *supra*, note 22, at 143.

6.2.1. Decriminalisation

It has already been seen that the use of the criminal law and, in particular, the use of strict liability is unpopular among both lawyers and business groups. Hardly surprisingly, therefore, there have been calls for decriminalisation. An influential Justice report in 1980 advocated a drastic reduction in strict liability offences and argued that the criminal law should be restricted to offences that are clearly *mala in se*.⁴⁰ Arguing that the use and proliferation of strict liability offences decreases respect for the criminal law, it recommended the creation of a category of 'contraventions' subject to civil penalties. Decriminalisation was also an option favoured by the Royal Commission on Criminal Procedure of 1981 and in the Law Society's recommendations to the *Keith Committee on Revenue Law* that observed that:

*'Routine regulatory mechanisms should not, in the tax field, be fenced with criminal sanctions. Automatic civil surcharges and penalties are more appropriate, and more reliable in their application.'*⁴¹

Decriminalisation has also been proposed by *Tench* who suggests that consumer and other regulatory offences should be dealt with in a new 'middle system of law', which would be neither civil nor criminal. This would remove the sense of grievance expressed by offenders and could lead to higher penalties:

*'... under the new system the court may well feel much more at ease in awarding a civil penalty that really hurts, once the obloquy of a criminal conviction is removed from the transgression.'*⁴²

40 Levi, M. (1984), 'Business Regulatory Offences and the Criminal Law', *Company Lawyer*, Vol. 5, No. 6, at 253 *et seq.*

41 Levi, M. (1984), *op. cit.*, at 257.

42 Tench, D. (1981), *Towards a Middle System of Law*, London: Consumer's Association, at 21.

For ‘*crooks*’ and ‘*real fraud*’, Parliament should determine that some acts are to be considered as ‘*wicked and forbidden*’, while others should be considered to be ‘*not wicked*’, but in need of regulation. Public funds would be saved as many cases would not go to court. This system should be clearly distinguished from criminal law by using a different language-words like penalty, liability, contravention, transgression and violation would all be suitable unlike crime, offence, guilty or fine, imprisonment, prosecute and charge.⁴³

There are many problems with the kinds of proposals. Deterrence could be further undermined by the absence of public prosecutions.⁴⁴ In addition, while strict liability does enable defendants to minimise their blameworthiness and may lead to lower penalties, the difficulties of proving intent might lead to very few prosecutions of the really ‘*wicked*’, who would all presumably deny dishonesty or intent.⁴⁵ Despite the many protests about the injustice of convicting morally innocent business persons, selective prosecution policies and low penalties in themselves make such injustices unlikely.⁴⁶ Finally, many object to the ideological assumption underlying decriminalisation proposals that these ‘*contraventions*’ or violations are essentially different from crimes and offences.

Much of the responsibility for preventing and detecting white-collar offences lies with industry itself, either through the internal arrangements of individual companies and businesses, or through trade associations and self-regulatory organisations, like those that exist in the City of London. Many, offences are, indeed, more likely to be discovered within organisations than by outsiders, and many are dealt with by private policing and private justice.⁴⁷ Some self-regulatory

⁴³ Tench, D. (1981), *op. cit.*, at 19 *et seq.*

⁴⁴ See generally Borrie, G., Sir (1980), ‘*Laws and Codes for Consumers*’, *Monthly Review*, Vol. 88, No. 12.

⁴⁵ See generally Borrie, G., Sir (1984), *The Development of Consumer Law and Policy – Bold Spirits and Timorous Souls*, London: Stevens.

⁴⁶ Levi, M. (1984), *supra*, note 40, at 251 *et seq.*

⁴⁷ See generally Clarke, M. (1990), *Business Crime: Its Nature and Control*, Cambridge: Polity.

organisations can also disqualify offenders or apply other sanctions and industrial and trade associations also monitor compliance with standards.⁴⁸ The scope and significance of self-regulation is, therefore, enormous. Accordingly, many argue that far greater emphasis should be placed on improving and strengthening arrangements for self-regulation, which can be more effective and less costly, as many of the costs of enforcement are borne by industries or trade associations themselves.

Braithwaite and Fisse, on the basis of their research in the pharmaceutical and other industries, summarise the many benefits of self-regulation. Inspections carried out by company inspectors, they argue, can be more exhaustive compared to the often-ineffective coverage of government inspectors. Corporate inspectors tend to be better trained, have a more specialised knowledge of the company's operations, and are in a better position to detect cover-ups and set up traps for suspected wrongdoers. To be effective, however, self-regulatory arrangements must have informal clout and management backing. Ideally, there should be provisions for accountability for compliance through line management accompanied by effective monitoring. In addition, problems must be effectively communicated to those capable of taking action and those involved should be adequately trained and supervised.⁴⁹

While few dispute that self-regulation can be more effective than public regulation, many doubt whether its potential can be realised, as many industries and especially trade associations have shown a marked reluctance to institute systems with sufficient clout. As *Braithwaite and Fisse* point out, industries often need to be threatened by increased state regulation before they are prepared to institute sufficiently rigorous controls.⁵⁰ Furthermore, much self-regulation has been criticised for prioritising industrial interests, and giving less weight to the interests of workers, consumers or the public at large.⁵¹ The practical effects of self-regulation

48 Braithwaite, J. and Fisse, B. (1987), 'Self-Regulation and the Control of Corporate Crime', in Shearing, C. and Stenning, M. (1987), *Private Policing*, London: Sage Publications, at 76 *et seq.*

49 Braithwaite, J. and Fisse, B. (1987), *op. cit.*, at 45.

50 Braithwaite, J. and Fisse, B. (1987), *supra*, note 48, at 34.

51 Cranston, R. (1984), *Consumers and the Law*, London: Butterworths, at 23 *et seq.*

can, therefore, be limited. A further objection to an over-emphasis on self-regulation is that it is not publicly accountable and offenders are not publicly prosecuted.⁵²

On the other hand, state and self-regulation can and do operate side by side, and as *Braithwaite* argues, to be effective self-regulation should be backed up by stiffer penalties, a combination central to his proposed theory of re-integration shaming.⁵³ Self-regulation should, he argues, attempt to foster corporate cultures in which an absence of compliance is seen as morally wrong, and should be based on trust and co-operation, involving all employees. He therefore rejects the kinds of self-regulatory systems which increase levels of monitoring and surveillance and create more and more ‘*auditors*’ and ‘*monitors*’ which, he argues, merely exacerbate the diffusion of responsibility and in which organisational complexity is used to ‘*protect people from their own consciences*’.⁵⁴ To encourage the development of such a culture, organisations should encourage ‘*whistle-blowing*’ and going direct to the top where non-compliance is found.⁵⁵ Trust is essential in such a system, where everyone is a guardian and no one is the ultimate guardian.

⁵² Clarke, M. (1987), ‘*Prosecutorial and Administrative Strategies in the Control of Business Crime: Private and Public Roles*’ in Shearing and Stenning (eds) (1987), *supra*, note 48.

⁵³ Braithwaite, J. (1989), *supra*, note 22, at 101 *et seq.*

⁵⁴ Braithwaite, J. (1989), *supra*, note 22, at 147 *et seq.*

⁵⁵ *Whistle-blowing* has now been afforded statutory protection by Parliament although it is too early to say whether the position regarding issues of non-compliance being reported.

6.2.2. Administrative Sanctions

The many powers and sanctions available to both self-regulatory organisations have already been outlined. These powers have many advantages. They are deterrent, as they threaten the very survival of a business they protect the public and prevent further offences. Accordingly, there are many suggestions that they should be extended and used more often.

In certain circumstances, offenders can be disqualified. Such incapacitation can be achieved, argue *Braithwaite and Geis* 'swiftly and without barbarism'.⁵⁶ In Britain, individuals can be prohibited from running financial service businesses, and from professional practice in accountancy if they are deemed to be not a '*fit and proper person*'.⁵⁷ Such a judgement is not necessarily related to offences, as convictions are neither a necessary nor sufficient condition for being banned, and they can be made where a lack of commercial probity, gross negligence or total incompetence is present. Theoretically, these powers are deterrent and punitive, and also incapacitative. However, there are some practical problems. Where individuals have not been convicted, it may be difficult to obtain sufficient evidence to demonstrate whether or not someone is a '*fit and proper person*' and, of course, many at one time considered to be '*fit and proper*', nonetheless, commit offences.⁵⁸ *Levi* also points out that disqualified persons can readily set up new companies under a front person who has not been disqualified. What *Braithwaite* further limits the effect of disqualifications and *Geis* describe as substitution problems - one person within a business or corporation may be removed, but subsequently replaced by another person

56 Braithwaite, J. and Geis, G. (1982), *supra*, note 27, at 307.

57 Levi, M. (1987), *supra*, note 2 and Levi, M. (1989) '*Fraudulent Justice? Sentencing the Business Criminal*' in Carle, P. and Cook, D. (ed.) (1989), *Paying for Crime*, Oxford: Martin Robinson, at 88 *et seq.*

58 Levi, M. (1987), *supra*, note 2, at 348. The notion of justifiable evidence through self-incrimination has for some time been argued given the decision reached in *Ernest Saunders* case and the implications it has on civil liberties; see, for example, Sarker, R. (1997), '*A Pyrrhic Victory for Ernest Saunders*', *European Financial Services Law*, Vol. 4, No. 3, at 111 *et seq.*; Edenborough, P. (1997), '*Use of Statements Given Under a Legal Compulsion*', *Student Law Review*, Vol. 21, at 36 *et seq.* and Mason, K. (1997), '*Litigator's View*', *Lawyer*, Vol. 11, No. 5, at 12.

who may be prepared to commit the same offences.⁵⁹ Finally, of course, they are only applicable where qualifications are required except with the case of directorship where the court may impose a ban.

The power to grant or withdraw licences also has considerable potential, in that it is preventive and threatens profitability and survival. Indeed, these powers can shift the balance of power in favour of regulators.⁶⁰

Many self-regulatory organisations and public enforcement agencies can also impose financial penalties, powers that many argue should be increased, which is implicit in proposals for decriminalisation. They also have a considerable deterrent value and amount to punishment while avoiding costly and risky prosecutions. Other strategies can also provide financial disincentives to offend.

⁵⁹ Braithwaite, J. and Geis, G. (1982), *supra*, note 27, at 79 *et seq.*

⁶⁰ Pearce, F. and Tombs, S. (1990), 'Ideology, Hegemony and Empiricism: Compliance Theories and Regulation', *British Journal of Criminology*, Vol. 30, No. 4, at 424 *et seq.*

6.2.3. *Criminal Law and Enforcement*

However effective many of these administrative measures may be, most accept that the criminal law must be used as an ultimate sanction, if only for the most recalcitrant or 'wicked' offenders. Others argue further that the criminal sanction is also necessary to underline moral disapproval of activities that are criminal offences. Furthermore, private justice is not publicly accountable and leads to a situation in which a different set of rules is applied to different groups of offenders, a situation which would be exacerbated by a greater emphasis on alternatives to prosecution. Accordingly, therefore, there have been many suggestions for strengthening criminal law, and making both enforcement and sentencing policies more punitive.

Against the view that the criminal law is inevitably limited, it could be argued that many of its gaps and loopholes could be plugged. It is impossible to examine here the many proposals for strengthening different laws that include proposals for the criminalization of many fraudulent practices. The law could, for example, clarify the duties and responsibilities of company directors.

The creation of laws is undoubtedly important, but when created they have to be enforced, and there are many ways in which enforcement could be strengthened. Previous chapters have shown how resource constraints can lead to a lower rate of detection and prosecution that, in turn, reduces the deterrent and preventive value of the law. Accordingly, there have been many calls, not least from enforcement agencies themselves, for increased resources.⁶¹ It could, of course, be argued that the allocation of extra resources to the police force has not so far affected the upward trend in the crime rates. More resources for regulatory enforcement agencies would enable them to carry out more inspections and testing, which would increase their chances of detecting offences and, thereby, improve public protection. Allocating more resources to enforcement might, in turn, result in a greater number of prosecutions, which can be justified on the grounds of both deterrence and justice. It could be argued, for example, that for some, particularly high status offenders, public

⁶¹ Bruce, T. (1999), 'Collective Responsibility Must be Felt if Fraud is to be Tackled Effectively', *The Times*, 13/5/99.

prosecution in itself might enhance an important deterrent and public awareness of offences. A higher rate of prosecutions would also reduce the inequities produced by the present situation in which business and white collar offenders are more likely to be subject to private justice and less to public justice than conventional offenders.

6.2.4. *Making Offenders Pay*

While more prosecutions might constitute a deterrent, insignificant fines could well undermine this. Raising the level of fines is therefore, seen by many commentators as imperative. Increasing maximum fines and encouraging the use of higher fines within the permitted range can do this. Many argue, for example, that fines should better reflect the illegal profits made offences.⁶² Fines could also be more closely related to the offender's ability to pay. There have been many arguments for the adoption of a 'unit fine' system in which fines are calculated on the basis of units that are then related to the offender's means. These have now been introduced and their effect on fines for white-collar offenders could be substantial. *Levi* argues not only that very large fines should be imposed where appropriate, but that the media should be encouraged to take a more sophisticated attitude when reporting sentences by relating fines to offenders means.⁶³ The introduction of unit fines and the raising of fines for many regulatory offences have implicitly accepted many of these points.

It could be objected that fining companies too severely could penalise innocent parties like shareholders whose dividends might be cut or consumers who might suffer if the cost of fines were passed on by way of higher prices. However, both *Braithwaite* and *Leigh* argue that shareholders accept an element of risk by investing and also those companies may not be able to raise prices in competitive markets.⁶⁴ Punitive fines could also make shareholders ask more questions about the responsibilities of senior executives.⁶⁵ One problem that could arise in relating fines to offenders' ability to pay is how this ability can be ascertained. As *Levi* points out,

62 See generally Braithwaite, J. (1984), *Corporate Crime in the Pharmaceutical Industry*, London: Routledge and Kegan Paul at 68 *et seq.*

63 Levi, M. (1989), *supra*, note 57, at 54.

64 Braithwaite, J. (1984), *supra*, note 62 and Leigh, L.H. (1977), 'Policy and Punitive Measures in Respect of Economic Offences', in Leigh, L.H. (ed.), *Criminological Aspects of Economic Crime*, London: Butterworths, at 5 *et seq.*

65 Geis, G. (1978), 'Deterring Corporate Crime' in Ermann, M.D. and Lundman, R.J. (eds.) (1978), *Corporate and Government Deviance*, Oxford: Oxford University Press, at 142 *et seq.*

the self-reported income and debt statements of the accused is not the most valid method of data gathering in professional fraud or organised crime cases.⁶⁶

In addition to fines, offenders can also be made to pay through the imposition of compensation orders or the confiscation of assets. For example, courts may order confiscation of assets in cases of serious frauds, involving sums of over £10,000. However, *Levi* points out that these powers may be limited in practice, as assets may be in foreign bank accounts that are difficult to access.⁶⁷ Compensation orders can also add to the total financial penalty, and can be used where fines are low to increase the total sum. There are, therefore, many ways in which offenders can be made to pay for their crimes. However, financial penalties for the very rich can still be of limited value as they may have to be very high to be sufficiently deterrent and they may not have an equitable effect - they can, for example, perpetuate the situation in which the rich can pay for their crimes whereas the poor are less able to do so.⁶⁸

⁶⁶ Levi, M. (1987), *supra*, note 2, at 58 *et seq.*

⁶⁷ *Op cit.*

⁶⁸ Cook, D. (1989) 'Fiddling Tax and Benefits: Inculcating the Poor, Exculpating the Rich' in Carlen, P. and Cook, D. (eds), *Paying for Crime*, (1989), at 135 *et seq.*

6.2.5. *Imprisonment*

While many argue that sentences should be more punitive, it is not easy to determine how this can be done. An obvious suggestion is that more white-collar offenders should be sent to prison for longer periods of time on the grounds that the threat of imprisonment is deterrent, and that it is widely regarded as the most severe sanction under the criminal law.⁶⁹ *Geis* also argues that more use of imprisonment would be retributive, and would encourage moral outrage and media attention.⁷⁰ On the other hand, arguing for more prison sentences contradicts the general consensus that prison serves little more useful purpose and that its use ought to be reduced.⁷¹ It could also be seen as somewhat ironic to suggest that rich and wealthy offenders should be maintained at the state's expense.

Even when imprisoned, white collar offenders continue to enjoy favourable treatment, more often being sent to open prisons on the assumption that they present a smaller security risk. They are more likely to be paroled, and less likely to be seen as being in need of rehabilitation.⁷² Some of the Guinness defendants were sent to Ford open Prison which has a more relaxed regime, and where offenders could issue business instructions, freely use the phone and write letters. White-collar offenders' experience of prison may, therefore, involve fewer pains than that of conventional criminals.

69 Levi, M. (1987), *supra*, note 2, at 66 *et seq.*

70 Geis, G. (1978), *supra*, note 65. See also Durston, K. (1996), 'Fraud Trials: Is There a *Via Media?*', *Criminal Lawyer*, Vol. 67, at 7 *et seq.*

71 Braithwaite, J. (1984), *supra*, note 62, at 76 *et seq.*

72 Levi, M. (1987), *supra*, note 2, at 51 and Doig, A. (1984), *Corruption and Misconduct in Contemporary British Politics*, (1984), at 126.

6.2.6. Incapacitation

Despite the apparent difficulties of incapacitating white-collar offenders, *Braithwaite and Geis* argue that:

*'...although incapacitation is not apt to be very effective or acceptable for controlling traditional crime in a humane society, it can be a highly successful strategy in the control of corporate crime. Indeed, it can be more workable with corporate crimes because their kind of criminal activity is dependent on their being able to maintain legitimacy in formalised roles in the economy.'*⁷³

While these strategies may be both deterrent and preventive, their potential use and effect is likely to be somewhat limited. *Box* comments, for example, that they might well be seen as '*draconian and ideologically repugnant*'.⁷⁴ In addition, *Levi* points out that the individuals involved could set up new operations under assumed names or in countries less stringently regulated.⁷⁵

⁷³ Braithwaite, J. and Geis, G. (1982), *supra*, note 27, at 307.

⁷⁴ Box, S. (1983), *Power, Corruption and Mystification*, London: Tavistock, at 9 *et seq.*

⁷⁵ Levi, M. (1987), *supra*, note 2, at 53 *et seq.*

6.2.7. *Shaming Offenders*

Publicising offences can be a major deterrent and can also, argues *Box*, act as a catalyst by raising public consciousness.⁷⁶ Publicity is also central to the shaming strategies outlined by *Braithwaite* who points out that as white-collar offenders have a more profound stake in conformity they are deterred more by adverse publicity.⁷⁷ This view is also echoed by *Chambliss* who believes that white-collar criminals are among the most deterable types of offenders because they do not have a commitment to crime as a way of life and their offences are not spontaneous but are rather calculated risks.⁷⁸ There is considerable evidence that white-collar offenders do fear adverse publicity. For instance, *Benson* found that offenders whose cases had been reported felt embarrassed or embittered, whereas offenders whose cases had not been reported felt relieved.⁷⁹

Nonetheless, despite the considerable publicity surrounding major cases, publicity does not inevitably follow conviction, especially for regulatory offences, which are often heard in lower courts, and only irregularly covered by the media. Therefore, many argue that courts should have powers to order some kind of publicity. However, determining the form that court ordered publicity might take creates difficulties. There have been some experiments with ‘*corporate atonement*’ policies in the United States, where companies are required to pay for advertisements correcting misleading ones, but companies often used specialist journals, rather than the consumer journals used for the original advertisements.⁸⁰ *Levi* also argues that courts could require firms to take out an advertisement in either the local or national press to publish details of their violations. *Fisse and Braithwaite* recommend a variety of schemes including adverse publicity orders as a formal sanction, calling

76 *Box*, S. (1983), *supra*, note 74, at 32 *et seq.*

77 *Braithwaite*, J. (1989), *supra*, note 22.

78 *Chambliss*, W.J. (1988), *Exploring Criminology*, New York: Macmillan, at 54 *et seq.*

79 *Benson*, I. (1985), ‘*Denying the Guilty Mind: Accounting for Involvement in a White-Collar Crime*’, *Criminology*, Vol. 23, No. 4, at 294 *et seq.*

80 *Box*, S. (1983), *supra*, note 74, at 43.

press conferences immediately after corporate convictions, and encouraging investigative journalism by rationalising defamatory laws.⁸¹

However, the use of adverse publicity as a form of deterrence has not been without its critics as an apt way of dealing with white-collar offenders. Schemes invoking adverse publicity have been deemed ineffective in cases where the perpetrator is a large organisation. In other words, large multination conglomerates are unlikely to be affected by a few misplaced publicity campaigns. Likewise, given that sometimes there is a strong conflict of interest between the pursuer and the pursued, illustrated previously with the case of Jeffery Archer and Michael Hesletine, adverse publicity may be diluted or manipulated for the sake of damage limitation.⁸²

Fisse is also not clear over the true value of publicity as a sanction. He has noted that the case for using publicity, as a deterrent measure is weak if infliction of monetary loss is the only effect desired. He suggests that a much stronger case can be made out if it is sought to achieve deterrence by inducing loss of prestige or respect, provided that '*prestige*' and '*respect*' are not merely qualities that reflect financial standing.

81 Fisse, B. and Braithwaite, J. (1983), *The Impact of Publicity on Corporate Offenders*, Albany: New York University Press.

82 It should be noted that in this case although there may have seemed to be a conflict of interests, in reality such a scenario would be dealt with by high ranking civil servants first before passing any report to the M.P. in charge of the investigation. Reporters in this case tended to sensationalise the story first ignoring this point. It was in only later editions of this story that this fact was added.

6.3. Summary

The superior resources of some, though not all defendants, can be used to present more credible defence strategies, many of which exploit the many ambiguities in the law itself and the ambiguities criminal status of offences. This enables many defendants to deny imputations of blame, to present themselves as fundamentally honest and reputable business persons and thus, of course, as undeserving of harsh punishment. They may be able to control potentially damaging information about the persistence and seriousness of their offences, even though this may be a factor precipitating prosecution.

While cases prosecuted are likely to represent the more '*heinous*', serious or persistent offences, this is not evident in court as the long history of warnings and negotiations that typically precedes prosecution is not relevant. Defendants are, therefore, able to portray offences as trivial, technical matters, which are isolated incidents or unavoidable accidents. The strategic nature of these presentations can be seen in the reactions of enforcement officers in court who are often cynical and critical when hearing defences. Many complain that magistrates may be taken in by what they see as posturing, and may misunderstand the nature of enforcement policies.

The credibility of defence presentations further reflects the ambiguous criminal status of white-collar offences. *Levi*, for example, points out that there is a fundamental distinction between '*excusing*' the activities of fraudsters as '*common practice*', when similar attitudes would certainly not prevail towards lower class defendants.⁸³

Defendants' arguments are therefore made more credible because their offences are assumed to be less criminal than others. Appeals to business values assume that business offences are not really criminal. As *Levi* points out, suggestions that the jury be abolished in complex fraud cases are more acceptable because fraud is not seen as

a '*real*' crime.⁸⁴ If this were to be suggested for real crimes it could be seen as infringing a basic principle of criminal justice.

⁸⁴ Levi, M. (1983), *supra*, note 19.

Chapter Seven

The Problems Associated with the International Element

Overview

This chapter critically analyses the issue of extraterritoriality and its impact on fraud investigations. It seeks to emphasise the problems and developments undertaken by the United States and United Kingdom in an effort to improve their methods of detection and prosecution of financial criminals who embrace the use of multi-jurisdictions to mask their evidential trails.

This chapter is divided in four parts. Part one examines the general problems associated with extraterritoriality and its impact on financial crime. Part two examines the conflicting judicial reasoning adopted under United Kingdom common law and examines the impact legislation has had in this area. Part three offers a contrasting perspective on how the United States has dealt with this problem.

Finally, part four examines the problems associated with memoranda of understanding and treaties, and the effect they have on the extraterritoriality.

7.1. Jurisdiction, Money Laundering and Fraud

Regulatory and prosecution agencies are often faced with perplexing issues when securities frauds or insider dealing cases crosses over state boundaries.¹ It emphasises the fact that securities and futures markets² are equally hit by similar problems associated with extraterritoriality and that they invariably fail to recognise jurisdictional and political considerations place upon the process of regulatory enforcement until it is too late. All too often it is stated and reiterated in one form or another that:

“... Securities regulation is local [and that] securities trading is international...”³

Yet the impact of extraterritorial application has become all the more emphasised given that there is a more pronounced blurring between state boundaries mainly due to

¹ For the purposes of this chapter the issues concerned with manipulative practices are largely ignored due to the nature of section 47(2) *Financial Services Act 1986* which essentially includes provisions for issues of extraterritoriality in section 47(5) *FSA'86*.

² Although fraud centring on futures exists due to the nature of this research and because of word restraints imposed by university regulations only fraud associated with general securities will be discussed. However, this is not to say that there are not a number of outstanding articles on derivative fraud and the problems faced by the notion of extraterritoriality. Therefore, see Swan, N. (1995), ‘*The International Reach of American Derivatives Regulation*’, *Futures and Derivatives Law Review*, Vol. 2, No. 2, at 48 *et seq.*; Prezioso, D. and Cook, C. (1994), ‘*Current Regulatory Proposals Regarding the Derivatives Activities of United States Broker-Dealers*’, *European Financial Services Law*, Vol. 1, No. 2, at 56 *et seq.*; Malkin, N. (1985), ‘*Extraterritorial Application of United States Commodity and Securities Laws to Market Transactions in an Age of Intercontinental Trading Links*’, *North Western Journal of International Law and Business*, Vol. 7, at 351 and Earls, D. (1984), ‘*Extraterritorial Application of Fraud Provisions of the Commodity Exchange Act*’, *Washington and Lee Law Review*, Vol. 41, at 1215.

³ Levi, M. (1993), ‘*White-Collar Crime: The British Scene*’ in Geis, G. and Jesilow, P. (eds.), *White-Collar Crime: Special Issue of the Annals of the American Academy of Political and Social Science*, Newbury Park, Ca: Sage, at 79 *et seq.*:

‘...almost all serious securities frauds involve extraterritorial informational needs on the part of national agencies ... [with 80% of cases investigated in London having] some cross-border aspects.’

the utilisation of modern telecommunications and technological advancements.⁴ Indeed the waters of investigation are further muddied given that purely domestic attempts to deal with unlawful security activity are, at best, cumbersome.⁵ Moreover, the definition of extraterritoriality,⁶ jurisdiction and fraud⁷ are often ill defined or even intertwined.⁸ Therefore it is not surprising that the problems associated with the concept of the extraterritorial application of securities regulation has aroused considerable debate and comment.⁹

4 Rutledge, D. (1997), 'The Internet and United States Financial Markets', *European Financial Services Law*, Vol. 4, No's. 11 and 12, at 304 *et seq.* and Courtney, E. (1998), 'The Sky's the Limit', *The Banker*, Vol. 148, No. 864, at 52.

5 See figures in chapter one. Interestingly a possible solution to this problem was originally proposed by a *Royal Commission Report on the Law of Indictable Offences* in 1879:

"... Every offence shall ... be deemed to be committed at any place where any act is done or omitted the doing or omission of which forms a part of the offence, or where any event happens necessary to the completion of the offence, whether the person accused was at such place or not at the time of such an act, omission or event ..."

6 *The Roskill Committee Report on Fraud Trials*, (1986), at paragraph 2.28 *et seq.*:

"... At present there are no statutory provisions expressly covering the territorial jurisdiction of the criminal law of England and Wales. In principle, the criminal law is territorial, confined to acts performed in England and Wales. However, problems in determining where an offence has been committed may arise, in particular where the offences contains more than one main element, some elements taking place here and others abroad..."

7 *Roskill* (1986), *op cit.*:

"... Fraud is not a defined term: there has never been any general offence of criminal fraud in English law. There are in fact several hundred criminal offences on the statute book, together with a few common law offences, which may form the basis of a charge of fraud, in that one of the main ingredients of what is generally understood to be fraud may be present, such as dishonest practice, deception, false disclosure, concealment of assets or other activities of that nature..."

8 'The English court has power to try any defendant who is properly brought before the court. In that sense the court always has jurisdiction over the defendant. But if the defendant is alleged to have committed an offence outside the territorial jurisdiction of the court, then unless the offence is an extra-territorial one, he has committed no offence against English law. The court would have jurisdiction over the defendant, but he could not be indicted.'

R v. Governor of Pentonville Prison, ex parte Osman [1990] 1 W.L.R. 277 at 289, *per Lloyd LJ*.

9 Hermann, D.H.J. (1986), 'Extraterritorial Criminal Jurisdiction in Securities Laws Regulation', *Cumberland Law Review*, Vol. 16, at 207 *et seq.*; Murano, J. (1984), 'Extraterritorial Application of the Antifraud Provisions of the Securities and Exchange Act of 1934', *International Tax and Business Lawyer*, Vol. 2, at 298 *et seq.*; Mizrack, D. (1975), 'Recent

Yet once trans-national elements come into force the problems assume near impossibility.¹⁰ It is a fact that once matters of jurisdiction are raised issues relating to sovereignty and domesticity enter the political arena.¹¹ Therefore, extraterritorial issues can uncover unsettled scores between jurisdictions or regulators.¹² Combined with matters relating to choice of law, judicial policy making and the general cost effectiveness that warrants the deployment of state resources, the international element has become a fundamental problem.¹³ *Ashe* aptly highlights this by stating:

Developments in the Extraterritorial Application of Section 10(b) of the Securities Exchange Act of 1934, Business Law, Vol. 30, at 367 *et seq.*; Note (1978): 'Extraterritorial Application of the Antifraud Provisions of the Securities Acts', Cornell International Law Journal, Vol. 11, at 137 *et seq.*; Note (1969): 'Extraterritorial Application of the Securities Exchange Act of 1934', Columbia Law Review, Vol. 69, at 94 *et seq.*; Note (1976): 'American Adjudication of Transnational Securities Fraud', Harvard Law Review, Vol. 89, at 553 *et seq.*; Note (1973): 'Extraterritorial Application of Section 10(b) and Rule 10b-5', Ohio State Law Journal, Vol. 34, at 342 *et seq.*; Note (1976): 'Extraterritorial Application of United States Laws: A Conflict of Laws Approach', Stanford Law Review, Vol. 28, at 1006 *et seq.*; Comment (1973): 'The Transnational Reach of Rule 10b-5', University of Pennsylvania Law, Vol. 121, at 1363 *et seq.* and Note (1978): 'Extraterritorial Application of the Federal Securities Code: An Examination of the Role of International Law in American Courts', Vanderbilt Journal of Transnational Law, Vol. 11, at 711 *et seq.*

- 10 Rider, B.A.K. (1995) *Address to Cambridge Symposium on Economic Crime*, (September):

"... It is only the most unimaginative and causal commercial criminal who would fail to take the elementary precaution of deploying the almost insurmountable hurdle of a second or third legal system in his scheme..."

- 11 Rubin, J. (1971), 'Multinational Enterprise and National Sovereignty: A Skeptic's Analysis', Law and Politics of International Business Law, Vol. 3, at 1:

'... The cult (of national sovereignty) has become mankind's major religion. The intensity of worship of the idol of the national state is of course no evidence that national sovereignty provides a satisfactory basis for the political organisation of mankind... The truth is the very opposite...'

- 12 See *R v. Ellis* [1899] 1 QB 230 and *R v. Holmes* [1883] 12 QBD 23.

- 13 However, possible solutions to some of these shortcomings have been suggested. See 'No Hiding Place', (August (1992)), Butterworths Journal of International Banking and Financial Law, at 356:

'... One result of the conventional arrangements for financing criminal investigations is that requests often lie unprocessed for want of resources. Prosecutors and police officers have some difficulty dealing with all domestic matters required of them, let alone overseas requests. It seems a pity that important international co-operation in this field should fail for want of resources when the more practical approach of asking requesting states to pay a contribution which would enable help to be 'brought-in' and might mean quicker results...'

*'... offshore deals in the securities markets are one of the many difficulties placed in the way of enforcement of insider trading laws. A determined insider or manipulator will go to a lot of trouble to cover his tracks, and those tracks may never be found. All it seems to require is an offshore nominee and a foreign bank account.'*¹⁴

Indeed, Rider has reiterated this on many occasions:

*'At the heart of the inadequate response to commercial crime is, however, the fundamental problem of jurisdiction. No matter what approach to jurisdiction the courts adopt, it is probable that in many cases of international commercial crime either the perpetrator, the victim, the medium for the commission of the offence, the proceeds, the evidence or the confederates will be beyond jurisdiction. Having regard to the profound problems that exist in obtaining evidence overseas, let alone in imposing jurisdiction on the perpetrator, there is a very strong temptation on the part of the prosecutors and investigators to give up. The general rule in most commonwealth countries is that only evidence which can be tested before the court, through cross-examination, is admissible in a criminal trial. Therefore, where the evidence is overseas, the practical difficulties in securing it and the cost involved generally render it unattractive to pursue the matter....'*¹⁵

¹⁴ Ashe, T.M., and Counsell, L. (1993), *Insider Trading*, London: Fourmat Publishing at 191 *et seq.*

¹⁵ Rider, B.A.K. (1985), 'Combating International Commercial Crime – A Commonwealth Perspective', *International Commercial and Maritime Law Quarterly*, Vol. 2, at 217 *et seq.*. See also Palmer, J.R.J. (1985), 'Combating Commercial and Economic Crime in a Practical Way', *Company Lawyer*, Vol. 6, at 78 *et seq.*

'Those who deal with commercial or economic crime need no words of mine to underscore the difficulties which invariably accompany such matters. This is so even where all the elements of detection, investigation and litigation lie within a single jurisdiction. When one or more of these elements (perpetrator, witness, evidence, assets to satisfy judgement and so on) lie on the wrong side of the judicial dividing line, then the skies become dark again...'

Such are the problems in attempting to secure a satisfactory result where there is an extraterritorial element that it has become self-evident that many cases will have to be abandoned or deemed to have no causative link with any offence committed within that jurisdiction due to the complexity of the issues involved.

It is no secret to financial criminals that a complete breakdown of regulation and investigation often occurs once any element of such a trans-national *modus operandi* is used. It is also abundantly clear that many organised crime syndicates effectively use financial markets and their global nature to 'wash' illegal profits or gains.¹⁶ Where most developed stock markets entail transactions in twelve or thirteen figure sums on a weekly basis, even a small amount of such a sum is very attractive. The fluidity of crime is a fact of life: the days of specialisation have gone, in ironic contrast to the trend in the securities markets they sometimes infiltrate. No longer does one type of criminal enterprise independently exist from another. There is often a fundamental blurring between the interactions of one distinctly separate faction of criminality against another.¹⁷ Indeed, in an age where daily technological breakthroughs have become commonplace the most prevalent medium for committing crime now involves the internet and anonymous computer networks rather than through 'normal' personal interaction.¹⁸

¹⁶ Rider, B.A.K. and French, H.L. (1979), *The Regulation of Insider Trading*, London: Macmillan, at 419:

'... Perhaps even more disturbing is the evidence that organised crime has been active in recent years in the field of securities frauds. There have been cases of suspected Mafia involvement with stock market manipulation and insider trading and in the Far East there are many indications that Chinese 'Triads' have been similarly attracted to the securities markets of Hong Kong and the Philippines...'

and Tupman, T. (1998), 'Where has all the Money Gone? The IRA as a Profit-Making Concern', *Journal of Money Laundering Control*, Vol. 1, No. 4, at 304 *et seq.*

¹⁷ This is particularly evident if one looks at former Eastern Bloc states and the impact organised crime has had on banking and financial services industries; Sinuraya, M. (1997), 'Integration of Criminal Capital from Russia into West European Markets: An Assessment of Threat', *Journal of Money Laundering Control*, Vol. 1, No. 1, at 34 *et seq.*

¹⁸ McKenna, D. (1998), 'Internet Fraud – New Dog, Old tricks', *In-House Lawyer*, Vol. 57, at 77 *et seq.*; Silverman, J.A. (1998), 'Liability in Cyberspace, Disclosure and Securities Fraud on the Internet', *Computer Law and Security Report*, Vol. 13, No. 6, at 447 *et seq.*; Benjamin, A. (1999), 'Jurisdiction and the Regulation of Financial Services on the Internet', *Financial*

As with all other types of enterprise money is often an essential factor in criminal activity. Often this is generated by criminality itself. Insider dealing profits, for instance, have been known to play their part in drug related activity and in some instances inside information has been exchanged for drugs. The Stock Exchange has for long been a favourite laundry for drug money. Like any other enterprise money is needed to fund manpower, facilitate official bribes, purchase necessary hardware and software and so on.¹⁹ Illegally obtained money has to be hidden in order to conceal the crime that 'earned' it.²⁰ This explains the necessity of 'money laundering'²¹ that has quite simply been described as '*... the crime of the 90's*'.²² Money generated by organised crime often finds its way into businesses that operate as 'fronts' that exist to obscure proceeds. Sometimes these fronts are small businesses; often they are banks

Regulation Report, at 22 *et seq.*; Mackintosh, R. (1998), 'Spoof Internet Adverts May Warn of Fraud', *The Financial Times*, 29/5/98 and 'Enforcement actions brought as SEC 'cleans up' Internet' (1999) *European Financial Services Law*, Vol. 6, No.3, at 91 *et seq.*

- 19 Sultzer, H. (1995), 'Money Laundering: The Scope of the Problem and Attempts to Combat It', *Tennessee Law Review*, Vol. 63, at 198 *et seq.*
- 20 The majority of money laundering is used to replenish dirty money earned through drug deals; Horowitz, E. (1985), 'Piercing Offshore Bank Secrecy Laws Used to Launder Illegal Narcotics Profits: The Caymen Islands Example', *Texas International Law Journal*, Vol. 20, at 134 *et seq.*
- 21 See generally Strafer, M. (1989), 'Money Laundering: The Crime of the 90's', *American Criminal Law Review*, Vol. 27, at 149 *et seq.* and Welling, N. (1989), 'Smurfs, Money Laundering, and the Federal Criminal Law: The Crime of Structuring Transactions', *University of Florida Law Review*, Vol. 41, at 287 *et seq.* See also President's Commission on Organised Crime: Record of Hearing II, 14/3/84, at v *et seq.*

"... Money Laundering – the process by which one conceals the existence, illegal source or illegal application of income, and then disguises that to make it appear legitimate – has long been a vital component in the activities of organised criminal groups... (P)rofessional money launders have displayed increasing sophistication in the methods used to launder vast sums of money from narcotics trafficking, illegal gambling and other illegal activities..."

The Chairman of the Hearing, Judge Kaufman added, at 7:

"...when criminals launder funds they avoid both taxation and the possibility of loss in civil forfeiture proceedings. Moreover, these foreign banking transactions which involve deposit of tens of billions of dollars in off-shore banks, also affect both national and international economies..."

- 22 Zelden, L.K. (1994), 'Money Laundering 101: Everything You Wanted to Know About Money Laundering But Were Afraid to Ask', at C-6 in *White Collar Crime*.

and financial houses;²³ and even the financial markets can end up facilitating the laundering process.²⁴ Thus it can inspire the national economy. *Naylor* notes:

*'... Since the late 1970's, when the world balance of payments statistics began to reveal those systematic growing discrepancies, the world has seen a dramatic rise in the organisational skills of white collar criminals - specifically their ability to control illegal markets, to render the operation of legal markets illegal, and to debauch the political systems that are supposed to keep their power in check...'*²⁵

Often the money passes through 'offshore' jurisdictions that preserve banking secrecy, into accounts held in the name of sham companies. All too often layers of nominees are used together with bearer stock companies to create innumerable maze-like schemes that are utilised to lose any evidential trail.²⁶ The amount of capital fleeing

23 Sultzer, H. (1995), *supra*, note 19, at 198.

24 While some countries actively combat money laundering and see it as a societal blight, other actively solicits the money launders' funds and see it as a solid source of revenue. For example, the Seychelles Islands reportedly enacted legislation in late 1995 that gives those who make \$10m investment in the island immunity from prosecution; Leander K. (1996), 'How Money Launderers are Fighting Back', *Global Finance*, at 54. However, this was allegedly dropped after pressure from United States officials.

25 Naylor, R. T. (1987), *Hot Money and the Politics of Debt*, Linden Press: Simon and Schuster, at 12 *et seq.*

26 *Law Commission: Jurisdiction Over Offences of Fraud and Dishonesty with a Foreign Element* (Law Commission No. 180) (27th April 1989):

'... Modern crimes of dishonesty often involve complex operations designed to conceal dishonest conduct and to make detection and conviction as difficult as possible, and the planning, preparation and execution of the many operations which are involved in a complicated swindle frequently take place in several different countries...'

and Rider, B.A.K. and French, H.L. (1979), *supra*, note 16, at 419:

'... The nominee device accounts for the frustration of more securities fraud investigations than any other single factor. This single device if employed with care will enable ... little risk of exposure...'

most developed countries in this way each year is estimated to be huge.²⁷ However, money laundering also exacts a price on a country's banking system. At best, legitimate businesses have been known to avoid or pull deposits out of countries that they suspect are involved in substantial money laundering. At worst, money laundering was an issue in the collapse of the *Nugan Hand Bank* in Sydney, *Banco Ambrosiano* in Milan, and most recently the *Bank of Credit and Commerce International (BCCI)* of London.²⁸

A feature common to criminal activity in the financial markets is the dependency of nations on each other for its effective control. This is one of the less attractive by-products of the economic and social internationalisation that is a feature of modern commercial life. By laundering money to obscure sources inevitably it comes to rest in a stable deposit country. This in some ways explains why the penetration by criminal elements into the financial world to both control and protect investments has been so prevalent. However, from the perspective of re-coupment it can therefore become quite impossible to define when cash ceases to be 'dirty'. Once successfully perplexed, laundered money has at this stage penetrated into the economy. Laundered money, while being used to control and protect other investments, can fund yet further investment which itself is used to facilitate laundering. There does come a stage in the perception of law enforcers and the business community when its immersion in legitimate business enterprise removes the taint of its immoral origin.²⁹

27 Estimates of the amount of money that is laundered in a year are staggering. The Financial Action Task for money laundering created by the G-7 estimated that \$300bn is laundered by United States drug dealers. While the United States' State Department believe it is nearer \$500bn; Baldwin, H. and Munro, K. (1994), 'Overview of International and American Responses', in *Money Laundering, Asset Forfeiture and International Financial Crimes*, Butterworths: London.

28 Staff of Senate Committee on Government Affairs, 98th Congress, 1st Session, *Crime and Secrecy: The Use of Offshore Banks and Companies*, (1993), at 5 et seq.

29 Rider, B.A.K. (1985), *Colloquium on Maritime Fraud*, October 23rd – 25th, at 7 et seq.:

"... The more criminal groups or their nominees are allowed to penetrate the legitimate business and financial world, the greater will be the likelihood of their operations spreading through the political and social fabric of the state..."

Attempts have been made recently in the United Kingdom,³⁰ the United States³¹ and many Commonwealth countries to hit at the profits of crime. This hits at proceeds, prevents further criminal financing, and provides a victim-orientated fund. Thus the overall picture must be of virtually every kind of criminal activity along the spectrum needing and generating money.

Jurisdiction presents the barrier to effective regulation and enforcement. Money can be spirited away into a bank in a secret jurisdiction via a myriad of physical and technological means. As *Naylor* explains:³²

*'... Complementing the spread of financial havens has been a rapid development of banking technology, specifically of electronic fluids - transfer system that functions virtually instantaneously...'*³³

In addition offenders can benefit from the current range of extradition-free jurisdictions, or from those where rendition is made prohibitively troublesome.³⁴ The basic job of information gathering between regulatory authorities can break down as a

³⁰ Jackson, J. (1997), *'Examining Criminal Organisations: Possible Methodologies'*, Transnational Organised Crime, Vol. 2, No. 4, at 84 *et seq.*

³¹ Berman, J. (1995), *'The United States Securities and Exchange Commission and Extraterritorial Jurisdiction: Regulating the Markets'*, Journal of International Business Law, Vol. 10, No. 6, at 243 *et seq.* and Newcomb, A. and Landry, S. (1993), *'How Foreign Governments Gain Access to US Information'*, Money Laundering Law Report, Vol. 4, at 5 *et seq.*

³² Naylor, R.T. (1987), *supra*, note 25, at 13.

³³ See, in addition, Budwitz, M. (1984), *'The Finicky Computer, the Paperless Telex and the Fallible Swiss: Bank Technology and the Law'*, Boston College Law Review, Vol. 25, at 260 *et seq.*

³⁴ Walmsely, K. (1978), New Law Journal, Vol. 128, at 253 *et seq.*

'... the complexities and restrictions of extradition procedures and the need to avoid unnecessary delay made it impossible to prefer charges which would have reflected the real extent of his misbehaviour...'

result of elementary misunderstandings, incomprehensible mistrust, or fastidious judicial pronouncement.

It is important not to underestimate the importance securities and futures markets plays in the world of international crime. Securities and finance houses have on many occasions been set up to launder criminal funds.³⁵ Indeed, there are continuing worries about the effects of domestic and international insider dealing on these markets.³⁶ One must also take into account the associated ethical problems in the securities markets and its allied professions of law, banking and accountancy.³⁷ In the light of this disquiet it also must be remembered that securities markets are entrusted with the public interest in that they reflect and indeed contribute to the economic and political well-being of the country.³⁸ Loss in confidence in the marketplace as a clean place to do business has its effects on the capital markets, the ability of companies to raise money abroad, the balance of payments and ultimately the economy as a whole.³⁹ Furthermore one must also bear in mind the effect on the economy of a nation when a massive fraud is affected within its society that can devastate public morale and political stability.⁴⁰ What is most insidious is the mask of respectability that these activities possess.

35 See generally Hamilton, K. (1986), *The Financial Revolution*, Longman:London, at 143 *et seq.*

36 Levin, J. (1985), 'The Conflict Between United States Securities Law on Insider Trading and Swiss Bank Secrecy Laws', *Journal of International Law and Business*, Vol. 7, at 318 *et seq.*

37 Santow, J. (1977), 'Regulating Corporate Misfeasance and Maintaining Honest Markets', *Australia Law Journal*, Vol. 51, at 547 *et seq.* and Levi, M. (1981), *The Phantom Capitalists*, Heinemann: London, at 124.

38 Lee, M. and Bishara, A. (1985), 'Securities Regulation and Market Efficiency', *International Review of Law and Economics*, Vol. 5, at 247 *et seq.*

39 Wraith, R.E. and Simpkins, E. (1963), *Corruption in Developing Countries*, Allen and Unwin, at 57:

'... (I) f the City of London had not ... been the city of probity and ethical standards it would not have dominated European finance in the way it did ... British trade and commerce depended on British incorruptibility...'

40 Rider, B.A.K. (1985), *supra*, note 29, at 6:

These localised considerations take on an awesome importance when one views them in the light of the dual (but to a great extent unrelated) processes of deregulation and internationalisation of the securities markets of the world. Deregulation in the City of London⁴¹ has followed the same process in New York.⁴² The internationalisation of the capital markets is a widely accepted fact at this stage.⁴³ The world's securities and futures markets have become increasingly linked⁴⁴ and, as a consequence, interdependent. This enhances the need for their effective regulation. The ethereal nature of capital market trading given technological developments has created '*the increasingly slippery nature of capital*'; as regards the similar nature of on-exchange futures trading, a United States tribunal had this to say:⁴⁵

"... a commodity futures contract has no lawful existence or being independent of the designated contract market on which it is traded.."

'... The effect of a major commercial scandal or even an attempted one, on the credibility, reputation and integrity of a government or political philosophy can have disastrous implications. Some countries, mindful of this danger have elevated the fight against economic crime to the level of almost national survival. Consequently, crimes such as exchange control violation and market manipulation are regarded much in the same way as treason...'

⁴¹ Lynton-Jones, I. (1986), '*Big Bang and the Stock Exchange*', Company Lawyer, Vol. 7, at 99.

⁴² Hamilton, K. (1986), *supra*, note 35, at chapter five.

⁴³ Merloe, P. (1986), '*Internationalisation of the Securities Markets: A Critical Survey of U.S. and E.E.C. Disclosure Requirements*', Journal of Comparative Business and Capital Market Law, Vol. 8, at 250 *et seq.*; Cohen, M. (1971), '*International Securities Markets: Their Regulation*', St. John's Law Review, Vol. 46, at 264 and '*Towards an International Securities Market*', (1973), Law and Policy of International Business, Vol. 5, at 358 *et seq.*

⁴⁴ Mann, K. *et al.* (1987), '*Current Issues in International Securities Law Enforcement*', American Bar Association Conference, at 211 *et seq.*

⁴⁵ *In the Matter of Wiscope, S.A.* [1977 – 1980 Transfer Binder] Comm. Fut. L. Rep (CCH) s20 – 785, at 23.

The multi-market trading of many of these contracts further complicates matters. Legal regulatory developments have not kept pace.⁴⁶ Trading and market making exist on a level free and insouciant of national boundaries yet regulation continues to cling to the shackles of jurisdiction and territoriality. The SEC has recognised the resulting hiatus in enforcement and has dedicated its major intellectual resources to future resolution of the problems in this area. The situation they and, indeed, many other major regulators of the world find themselves in is as follows:

*'... The development of this new and complex market system could rapidly overtake market professionals, government regulatory bodies and the international legal and financial communities before they can mould a legal framework for it. The jurisdictional and enforcement problems created for national law enforcers in an international trading environment are just beginning to be apparent...'*⁴⁷

The markets have recognised the opportunities presented by internationalisation and the consequent interdependence in facilitating the effective running of those markets. The financial sector, regulators and enforcement agencies have been slow to really recognise any meaningful way interdependence with regard to the prevention of market abuse.⁴⁸ The law is out of step with the reality it seeks to control.⁴⁹

46 Wickman, P. and Daily, T. (1982), *White Collar and Economic Crime*, D.C. Heath and Co., at 40 *et seq.*:

'... International law has neglected the area of international financial manipulations ... and fraudulent trans-national economic deals...'

47 Mann, K. *et al.* (1987), *supra*, note 44, at 210.

48 Stones, M. (1997), 'Identification and Verification under the Money Laundering Regulations: Problems with Compliance', *Journal of Financial Regulation and Compliance*, Vol. 5, No. 2, at 146 *et seq.*; Stephenson-Burton, R. (1998), 'Scalpel or Sabre: the Creation of a More Responsible Financial Community won't be Painless', *Journal of Money Laundering Control*, Vol. 1, No. 3, at 204 *et seq.*. See also generally Rider, B.A.K. (1997), 'The Conduct of those Who Handle Wealth Belonging to Others', *European Financial Services Law*, Vol. 4, No. 7 and 8, at 182 *et seq.*

49 This is particularly true in the case of developing countries or countries that 'turn a blind eye' to money laundering; see Wiener, R. (1997), '*Money Laundering: Transnational Criminals, Globalisation and the Forces of 'Redomestication'*', *Journal of Money Laundering Control*, Vol. 1, No. 1, at 52 *et seq.*.

7.2. *The United Kingdom's Approach to Extraterritoriality*

7.2.1. *'Result' and 'Conduct' Crimes in the United Kingdom*

In England criminal jurisdiction over cross-border fraud offences has tended to turn on the distinction between what has been referred to as '*result*' and '*conduct*' crimes. The former relates to those crimes that require for their completion not only the conduct but also the prescribed result, for example the dishonest appropriation of property by deception.⁵⁰ The latter relates to crimes of which the essence is the conduct of the accused. However this distinction has not passed without criticism.⁵¹ In the case of '*conduct crimes*' jurisdiction is determined by the location of the acts of the defendant, but in cross-border crimes the determination of the place of acting can present problems. Hence, in *Treacy v. D.P.P.*⁵² the accused wrote and posted in England a blackmailing letter addressed to a woman in Germany, where she received the letter. The House of Lords held, by a bare majority, that the demand was made, and therefore the offence was committed, in England when the letter was posted there.

In '*result crimes*' jurisdiction depends on the place where the proscribed consequence of the acts of the accused takes place. In *D.P.P. v. Stonehouse*⁵³ the main issue before the House of Lords was whether a former minister could be tried in England for an attempt to obtain property by deception. He had staged a fake

50 "... The offence is committed in England and justifiable by an English court if any part of the proscribed results takes place in England..."

 ; *Secretary of State for Trade v. Markus* [1976] AC 35, at 61, per Lord Diplock.

51 *Law Commission Consultation Paper on Jurisdiction over Fraud Offences with a Foreign Element*, (1987), at 11 et seq.. Also see generally *Law Commission Report*, No. 180, (1989).

52 [1971] AC 537.

53 [1978] AC 55.

downing in the United States after he had taken out, in England, substantial insurance policies on his life in his wife's name. He anticipated, as was the case that the news of his '*death*' would reach his wife (who was innocent of complicity) and she would then claim on the policies. In the course of deciding whether the courts had jurisdiction to try the offence of attempt, the House of Lords held that the basis of the court's jurisdiction to try the complete offence of obtaining property by deception was that the physical acts of the accused had caused the intended consequence in England that property belonging to another had been obtained by deception.

Similarly, in the case of *Secretary of State v. Markus*⁵⁴ an English company was established for the purpose of selling shares in an investment trust which was to be managed by a Panamanian company. The agents of the English company invited investors in Germany by means of misleading brochures to invest in the trust. The signed application forms were then transmitted from Germany to London, the investors' money having been deposited in a Swiss bank account. The manager of the English company was charged under *section 13 of the Prevention of Fraud (Investment) Act 1958*.⁵⁵

The court held it had no jurisdiction as part of the offence, the offering by the victim to take part in the scheme, took place abroad. The court held that this was not divisible from the '*taking part in the arrangement*'. Nonetheless the House of Lords held that although the offer was made by investors in Germany this did not preclude the offence of taking part in the arrangement; the court could try the offence as the victims did not become parties to the arrangement until the application forms had been processed in London. *Lord Diplock* held that the question as to whether jurisdiction existed or not depended on where the result took place, here the taking part of the offering.

⁵⁴ [1976] AC 35

⁵⁵ Section 47 *FSA '86* essentially re-enacts section 13. However, section 13 has been criticised on an number of occasions for ineffectiveness; Rider, B.A.K. (1978), '*The Crime of Insider Trading*', *Journal of Business Law*, at 19 *et seq.*

Other offences that have amounted in result crimes include *Board of Trade v. Owen*⁵⁶ where the House of Lords held that a conspiracy to defraud a German export control department in Germany was not an offence in England and were not triable. Likewise, in *R. v. Baxter*⁵⁷ the accused, who resided in Northern Ireland, posted fraudulent pools claims forms to promoters in Liverpool. The court held that it had jurisdiction to try the charge of attempt to obtain property by deception. It was held the attempt was still in being when the forms arrived in Liverpool.

However, these distinctions and their elaborations have led to some absurd and anomalous results, in which fraudulent activity in England designed to obtain property abroad has led to the English courts declaring themselves to be without jurisdiction. Thus in *R v. Harden*⁵⁸ the accused procured by fraudulent statements the posting to himself cheques in his favour from Jersey. It was held that because the gist of the offence was obtaining, the act was not done in England because the act of posting was completed in Jersey and property in the cheques passed to him outside the jurisdiction. Likewise, in *R v. Tomsett*,⁵⁹ although fraudulent steps were taken in England to procure the wrongful division of funds in foreign banks, there was no offence committed which was subject to the jurisdiction of the court. In *A.G. Reference [No. 1 of 1982]*⁶⁰ the defendants were charged with conspiracy to defraud an English company by selling counterfeit products abroad bearing the false name of the victim's company. *Lord Lane CJ* held the court had no jurisdiction. He asked what the '*true object*' of the conspiracy was. Since it was to obtain money from prospective purchasers in Lebanon it was immaterial that if the plan had been carried out some damage might have resulted to the English company. This case seems to

⁵⁶ [1957] AC 602 (HL).

⁵⁷ [1972] 1 QB 1.

⁵⁸ [1963] 1 QB 8.

⁵⁹ [1985] Criminal Law Review, at 369.

⁶⁰ [1983] QB 751.

represent a stubborn refusal to view damage done to the English company and illustrates a short-sighted attitude with regard to defrauded foreigners.

It is not surprising therefore that in 1987 the Criminal Law Team of the Law Commission concluded that when investigating the issue of fraudulent offences with a foreign element, the aforementioned rules excluded from the jurisdiction of English courts many cases which inflicted serious implications for the economic interests and the property of English banks, companies and individuals, and that they represented perverse judicial reasoning.⁶¹

⁶¹ *Law Commission Consultation Paper* (1987), London: HMSO, at 5.

7.2.2. *Extraterritoriality under United Kingdom Legislation and Otherwise*

Both insider dealing and market manipulation are quite unique offences within the United Kingdom due to the fact that they possess their own jurisdictional rules. Insider dealing, for instance, is covered under section 62 *CJA*⁶² while manipulative and misleading practices are covered under section 47(4) and (5) *FSA* '86. However, this has not stopped the United Kingdom from strengthening its position with regards to receiving and co-operating with requests from other jurisdictions in a bid to reap the benefits of reciprocity when carry out its own investigations.⁶³

The embracement of Memorandums of Understanding ('*MOU*') and specific legislation to '*grease the poles*' of bureaucracy has increased the United Kingdom's ability to assist other jurisdictions,⁶⁴ albeit at their cost sometimes.⁶⁵ However, this is not to say that overseas assistance is a streamlined process. There are many problems associated with providing vital information to one jurisdiction or receiving it from another. Given that major frauds are often detected by a minor accounting infraction or discrepancy general objections, dislike or mistrust must be ignored if progress is to be made. Informal groupings, with no defined agenda or purpose, and without formalised power, must not be allowed to develop. They should rather be used to provide a preliminary foundation to a more legally sure mechanism.

The creation of a system of effective and all embracing international agreements in this area is undoubtedly a major requirement. Ultimately one must hope for a multilateral treaty amongst the major markets' regulators. However the most

⁶² In addition see Article 10 of the *European Directive for Co-ordinating Regulations on Insider Dealing* and the *Extradition Act 1989*.

⁶³ See section 82(4) *Companies Act 1989* ('*CA* '89').

⁶⁴ See generally sections 82 – 91 and 196 *CA* '89.

⁶⁵ See section 82(6) *CA* '89.

effective securities regulation is by way of prevention. The *FSA '86* and indeed the securities regulation in the United Kingdom is mainly based on the philosophy of disclosure. Entry into the marketplace is dependent on provision of detailed information to regulators. After the grant of authorisation the person is subject to a system of notification regulations that should set off the alarm bells should something go wrong.

MOU's have for a number of years played a vital part in cementing relations between major players in the fight against financial crime. However, this system has not passed without criticism. Public policy grounds have been known to appear when a request is made from a jurisdiction that may not in the past have been forthcoming with information. Such a refusal of information ultimately hampers the object of *MOU's*. Perhaps the underlying difficulty of the system is that it does nothing to alter the national law of particular jurisdictions. However, in the long term a move towards standardisation of securities regulation and enforcement procedures is required.

Given that national boundaries have become increasingly irrelevant in the operation of the financial world thought needs to be put into place so that flexible procedures that facilitate co-operation between different jurisdictions come into existence. However, such steps can cause problems in that a jurisdiction that creates such laws may not be treated the same way in another jurisdiction. The notion of reciprocity is *the* key issue. Such observations were made in Parliament upon the enactment of the *Criminal Justice (International Co-operation) Act 1990*.⁶⁶ However, it has not been left up to the legislators solely to '*flesh out*' arrangements

66 '*First, having recognised the inadequacies of an existing legislation, we have been determined to secure arrangements which will place us in the first rank internationally in our ability to co-operate with other countries in this most important of areas. Secondly, we have sought to ensure that, once the measures which are proposed in the Bill have been enacted, we will be able to seek assistance from other countries to just the same extent, and in the same ways, as we are able to offer help to them. Thirdly, we have been conscious that, however much we may wish to assist other countries, we cannot ask Parliament to make greater powers available on behalf of overseas authorities than are available to our own police or prosecution authorities in domestic cases.*'

; House of Lords Official Report, 12/12/89, at paragraph 1217.

between jurisdictions. General unofficial agreements and procedures already exist as many regulators and investigators realise that the common good – the ability to catch the financial criminal and not facilitate him – needs to take precedent over individual or collective differences. The international element in financial crimes is prevalent in a large proportion of cases investigated. This element rarely diminishes. Therefore, it is of paramount importance that such arrangements, whether official or not, are observed and enforced.

7.3. *The Growing Scope of Extraterritoriality and American Securities Laws – From ‘Conduct’ and ‘Effect’ to Internet Sites*

In recent years, the *SEC* has given a territorial interpretation to the registration provisions and permitted foreign and domestic issuers to sell unregistered securities abroad to United States individuals and also given a territorial interpretation to its broker-dealer registration provisions. The *SEC* has also changed its views and reasserted its jurisdiction role over foreign-based transactions in order to protect markets within the United States.

Whether such jurisdictional expansionism is feasible or advisable in today's cyberspace markets, which are global in scope and regulated by foreign as well as United States regulators, is an interesting question since Congress contemplated that federal securities laws should be applied to trans-national securities transactions.

Originally, the term '*interstate commerce*' was defined in the *SEA* to include:

*'...trade, commerce, transportation or communication ...between any foreign country and any state, or between any state and any place or ship outside thereof'*⁶⁷

Under section 30(b) *EA* any individual is exempt from that *Act*'s provisions if:

*'... he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the commission may prescribe.'*⁶⁸

⁶⁷ Section 3(a)(17) *SEA* and 15 USC sections 77(b)(7), 78c(a)(17) (1997).

⁶⁸ 15 USC section 78dd(b) (1997). The *SEC* has never passed any rules to implement this section.

The interests of international law and comity might have been best served by giving the phrase '*without the jurisdiction of the United States*' a territorial interpretation. However, the *SEC* and the courts determined to give the *SEA* extraterritorial effect, interpreting '*jurisdiction*' as a legal rather than a geographical concept. This was aptly illustrated in *Bersch v. Drexel Firestone Inc.*⁶⁹ In this case a class action was brought by a large number of multinational plaintiffs against the Bernie Cornfeld financial empire. The action related to the securities of IOS Ltd., a company organised under the laws of Switzerland. The plaintiffs alleged that the underwriters impliedly represented to the public that IOS was suitable for public ownership when it was not; and that the prospectus failed to reveal illegal activities by IOS and its officers that had seriously damaged the company. The decision, and the judgement of *Judge Friendly* have important repercussions on the '*conduct*' and '*effects*' tests.⁷⁰ The judge concluded that since the fraud was committed by placing the allegedly false prospectus in the purchaser's hands, that there were no United States purchasers, the company was not identified with the United States economy and the plaintiffs were all foreign there were no effects within the jurisdiction of the United States that would warrant the use of United States law.⁷¹

By contrast, in *Kook v. Krang*⁷² the plaintiff sought damages for breach of margin requirements under section 7(c) *SEA*. The plaintiff was a New Jersey resident; the defendants were citizens and residents of Canada, partners in the defendant brokerage firm, itself a member of the Toronto Stock Exchange. The firm was not a member of a national United States exchange, but was registered as a broker-dealer under section 15 *SEA* as it maintained a New York office that dealt only in institutional and not private investors. The plaintiff's dealing on the Toronto Stock Exchange was less than successful. During this time, although all transactions were carried out in Toronto through the Canadian office, the plaintiff continually sought

⁶⁹ 389 F.Supp. 446, 453-55 [SDNY 1974], rev'd in part, 519 F2d 974 [2d Cir.], cert. denied, 423 U.S. 1018 [1975].

⁷⁰ *Ante* and *Post*.

⁷¹ *Supra*, note 69, at 986 *et seq.*

⁷² 182 F.Supp. 388 [SDNY 1960].

general market advice from the New York office. The employees there made no suggestions that led to purchases, although one offered general ‘*informal*’ advice as an acquaintance.

The court held that since the extension of credit in alleged breach of section 7(c) occurred in Canada and had no connection with the New York office there was no jurisdiction. On the question of section 30(b) the court stated:

*‘Whatever choice of law might be applied, these were Canadian transactions, and the use of the mails and telephone within the United States does not change the locale. The question is whether there are contracts with the United States sufficient to give this court jurisdiction, no one questions that, but rather whether Congress intended to make the statute applicable to these transactions. We hold that such was not the intention of the legislature and that jurisdiction as used in section 30(b) contemplates some necessary and substantial act within the United States...’*⁷³

However, the 1968 Second Circuit decision of *Schoenbaum v. Firstbrook*⁷⁴ was a landmark opinion explicating the law on the extraterritorial application of the *EA*. This was a derivative action brought by an American shareholder of a Canadian corporation, Banff Oil Ltd., whose shares were listed and traded on the American Stock Exchange. The complaint alleged that Banff sold treasury shares at a deflated price to two foreign companies. The plaintiff’s theory of the case was that its directors defrauded Banff and controlling stockholder who combined to force it to sell treasury stock at the prevailing market price when they knew this price was artificially low. The defendants argued that the court was without subject matter jurisdiction since the entire transaction in Canada between foreign corporations. The Second Circuit rejected that argument stating:

⁷³ *Op cit.*, at 390.

⁷⁴ 405 F.2d 200 [2d Cir. 1968], at 206 cert. denied sub nom. *Manley v. Schoenbaum*, 395 U.S. 906 [1969].

*"We believe that Congress intended the Exchange Act to have extraterritorial application in order to protect domestic investors who have purchased foreign securities on American exchanges and to protect the domestic securities market from the effects of improper foreign transactions in American securities."*⁷⁵

It further went on to state that section 10(b) *SEA* and the rules made under it could have extraterritorial effect. This would be so when there was a violation that was injurious to United States investors. Acts done outside the jurisdiction but intended to produce and producing detrimental effects within the jurisdiction may be punished as if the acts were committed within the jurisdiction. However, this decision has not been without criticism.

The court also discussed the effect of section 30 *SEA*. It pointed out that the *SEC* had not promulgated any rule exempting foreign transactions from rule 10b-5. It further stated that while section 30(b) was intended to exempt persons conducting securities business through foreign securities markets, it would not prevent extraterritorial application of the act to persons engaging in isolated foreign transactions. Therefore while technically there was an exemption in this *Act* this was subject to the Commission's discretion that could be used to prevent evasion of the *Act*. The court concluded that the exemption was to relieve the *SEC* from regulating persons against whom it could not bring its investigatory powers to bear. It is notable that the court delimited the effect of the section on the basis of possibility of enforcement. The court had the benefit of an *amicus* brief by the *SEC*. It stated that the *SEA* is:

'generally applicable extraterritorially wherever such application is necessary and appropriate for the protection of American investors and markets.'

⁷⁵ *Op. cit.*, at 206. Note that in the last decade the 'silence' of Congress on the issue of extraterritoriality has been noted. *Alfadda v. Fenn*, 935 F2d 475, 478 [2d Cir.], cert. denied, 502 U.S. 1005 [1991]. See also Sachs, S. (1991), 'The International Reach of Rule 10b-5: The Myth of Congressional Silence', Columbia Journal of Transnational Law, Vol. 28, at 677 *et seq.* arguing Congress intended the benefits of the Exchange Act to be enjoyed within the United States only.

Yet they maintained that the protective theory of jurisdiction was not meant by Congress to be taken to its absolute limits. They stated that Congress intended three bases of jurisdiction. The first was the ‘*jurisdictional means*’; the mails and other ‘*instrumentalities of interstate commerce*’. The second was regulation of persons in the securities business. As regards the securities exchange. The third was regulation of persons in the securities business. As regards the first element, the SEC argued that whether or not a transaction was foreign or domestic it was reasonable to apply United States law. They argued that section 30(b) was addressed to the third category:

‘The final group of operative provisions of the original version of the Act was applicable to persons in the securities business even in the absence of a registered security or use of a jurisdictional means ... (T)he ‘triggering’ element was the identity of the person involved in the transactions, not the nature of the transaction itself, and any particular foreign transaction might or might not have a sufficient impact on American interests to justify the direct application of the Act to the transaction irrespective of the participation or non-participation of someone in the securities business. In other words, although the United States might have power over a participant in a foreign transaction, the transaction itself might not have a sufficient impact on American interests and therefore not be within the direct legislative jurisdiction of Congress and under the Constitution and the law of nations. It was this problem that section 30(b) was addressed.’

Subsequently, the courts developed an alternative rationale for applying the securities laws extraterritorially – the ‘*conduct*’ test. Using this test, the courts applied the antifraud provisions of the securities laws to losses from sales of securities to Americans resident in the United States, to Americans resident abroad if acts of material importance in the United States contributed to the losses, and even to foreigners outside the United States if acts within the United States directly caused

their losses.⁷⁶ In *Leasco Data Processing Equipment Corp. v. Maxwell*,⁷⁷ the plaintiff an American corporation, alleged that the defendants, all United Kingdom citizens, had conspired to cause it to buy Pergamon stock at an unfairly inflated price in violation of section 10(b) *SEA*. Pergamon was a British Company listed on the United Kingdom stock exchange. It was neither listed nor traded on any United States exchange on any United States exchange. It was alleged that the fraud consisted in false and misleading statements by the defendants in London and New York to Leasco officials. The court held that because some alleged misrepresentations were made in New York subject matter jurisdiction was to be upheld.

Judge Friendly stated that:

*"...it was understood from the outset that all transactions would be executed in England. Still we must ask ourselves whether, if Congress had thought about the point, it would not have wished to protect an American investor if a foreigner comes to the United States and fraudulently induces him to purchase foreign securities abroad – a purpose which its words can fairly be held to embrace. While ... we doubt that impact on an American company and its shareholders would suffice to make the statute applicable if the misconduct had occurred solely in England, we think it tips the scales in favour of applicability when substantial misrepresentations were made in the United States."*⁷⁸

⁷⁶ *Robinson v. TCI/U.S. West Communications Inc.*, 117 F3d 900 [5th Cir. 1997]; *Zoelsch v. Arthur Andersen and Co.*, 824 F2d 27, 33 [D.C. Cir. 1987]; *Bersch v. Drexel Firestone Inc.*, 519 F2d 974, 993 [2d Cir.], cert. denied, 423 U.S. 1018 [1975]; *Leasco Data Processing Equipment Corp. v. Maxwell*, 468 F2d 1326 [2d Cir. 1972]. Some circuits require a lesser quantum of conduct, that the domestic conduct be significant to the fraud, rather than a direct cause of it. *SEC v. Kasser*, 548 F2d 109 [3d Cir.], cert. denied, 431 U.S. 938 [1977]; *Continental Grain (Australia) Pty. Ltd. v. Pacific Oilseeds Inc.*, 592 F2d 409, 420-21 [8th Cir. 1979]; *Butte Mining PLC v. Smith*, 76 F3d 287, 290-91 [9th Cir. 1996].

⁷⁷ 468 F. 2d 1326 [2d Cir. 1972].

⁷⁸ *Op cit.*, at 1337.

More recently, in *Itoba Limited v. Lep Group PLC*,⁷⁹ the subsidiary of a Bermuda based holding company, listed on the New York Stock Exchange Inc., sued Lep Group Plc., a London based holding company, with NASDAQ-listed ADRs, for omissions in its *Form 20-F* filed with the SEC. Based on these omissions and similar fraudulent information in Lep's United Kingdom annual reports, the plaintiff purchased shares of Lep on the London Stock Exchange, which resulted in a write-off of \$522 million. Further, an individual defendant who was a United States director of Lep sold shares through his United States broker that were sold to plaintiff on the London Stock Exchange. The court held there was subject matter jurisdiction under a combination of the '*conduct*' and '*effect*' tests.

Over the last two decades academics have also sought some form of resolution associated with the fundamental problems linked with extraterritoriality.⁸⁰ Hence, the *Federal Securities Code* was devised.⁸¹ The main provision is section 1905 that states that the *Code* applies within the limits of international law while the remainder is drafted with a prolixity causing doubts in the worth of thus '*clarifying*' the law.⁸² The *Code*'s principles are as follows:

- '(1) *establishing a broad, prima facie prescription for extraterritoriality;*
- (2) *subjecting the broad prescription to specific rulemaking authority;*
and
- (3) *restricting both the prescription and the rulemaking authority to the limits of international law.'*⁸³

⁷⁹ 54 F3d 118 [2d Cir. 1995], cert. denied 116 S.Ct 702 [1996].

⁸⁰ Loss, L. (1979), '*Extraterritoriality in the Federal Securities Code*', Harvard International Law Journal, Vol. 20, at 305 *et seq.*

⁸¹ *American Law Institute Federal Securities Code*, (1980).

⁸² Curtis, P. (1980), '*The Extraterritorial Application of the Federal Securities Code: A Further Analysis*', Connecticut Law Review, Vol. 9, at 67 *et seq.*

⁸³ Loss, L. (1979), *supra*, note 80, at 325 *et seq.*

The *Code* generally applies:

*'with respect to any ...prohibited required or actionable conduct' if the 'constituent elements' either 'occur to a significant (but not necessarily predominant) extent within the United States' or 'cause a substantial effect within (the United States) as a direct and reasonably foreseeable result of the conduct.'*⁸⁴

Nowhere in the cases is there a stipulation that the *'constituent elements'* occur within jurisdiction. Furthermore, the plural use of the word would seem to suggest that all constituent elements must so occur. This goes far beyond the cases and is infinitely less preferable to the flexible approach of the second circuit. Also, it sets an almost impossibly high standard as regards law enforcement in this area. The *Code* is intended to apply to an offer, purchase or sale of a security; a proxy solicitation; a tender offer, and any activity of an investment advisor.

The *Code's* antifraud provisions apply where conduct either occurs or is initiated in the United States. The *Code's* non-fraud provisions apply where the specified conduct:

*'occurs within the United States although ... is initiated outside the United States.'*⁸⁵

The *Code's* non-fraud provisions do not apply in the opposite situation, for example where an act *'that occurs outside the United States ... is initiated within the United States.'*⁸⁶ This is based on the sensible notion that the non-fraud provisions

84 Larose, L.A. (1984), *'Conflicts, Contracts and Co-operation: Extraterritorial Application of the United States Securities Laws'*, Securities Regulation Law Journal, Vol. 12, at 99 *et seq.*

85 Section 1905(a)(1)(A).

86 Section 1905(b)(1).

relate generally to the internal organisation of companies to which any extraterritorial application would offend sovereignty.⁸⁷

The *Restatement (Third) of Foreign Relations Law of the U.S.* also takes an expansive view of SEC jurisdiction, but emphasises 'reasonableness', placing some weight on comity and the need to accommodate the interests of foreign states.⁸⁸ In fact, although the SEC has always claimed the greatest possible jurisdictional reach, it has not attempted to impose its registration requirements on all transactions occurring abroad. Traditionally, the SEC took the position that the registration requirements of section 5 of the *Securities Act* were primarily intended to protect United States investors. In 1964 the Commission therefore announced that it would not take any action for failure to register securities of United States issuers distributed outside the territory of the United States to foreign nationals even though use of the jurisdictional means might be involved in the offering.⁸⁹

A serious change in the SEC's view of its own jurisdiction occurred in 1980 when the commission adopted both regulation S⁹⁰ pertaining to offshore offerings and rule 15a-6⁹¹ pertaining to broker-dealer registration

To qualify for regulation S, all offers and sales must be made in an 'offshore transaction', which means that no offers may be made to persons in the United States and either the buyer must be offshore when the buy order is placed or the sale must be made on a foreign securities exchange or through a designated offshore securities market.

⁸⁷ Loss, L. (1979), *supra*, note 80, at 307 *et seq.*

⁸⁸ American Law Institute, *Restatement (Third) of Foreign Relations Law of the United States*, (1987).

⁸⁹ Securities Act. Release No. 4708 (July 9, 1964). See also *Securities Act* Release No. 5068 (1970).

⁹⁰ 'Offshore Offers and Sales', 17 CFR section 230.901-04 (1997), adopted in *Securities Act* Release No. 6863 (April 24, 1990), 55 Fed. Reg. 18306 (May 2, 1990).

⁹¹ 17 CFR section 240.15a-6 (1997), adopted in *Exchange Act* Release No. 27017 (July 11, 1989), 54 Fed. Reg. 30013 (July 18, 1989).

'Directed selling efforts' into the United States, that is, activities that condition the United States market for the securities offered destroy the 'offshore transaction' safe harbour. The issuer safe harbour in regulation S distinguishes among categories of securities based on the nationality and reporting status of the issuer and the extent of United States market interest in the issuer's securities. As a practical matter, regulation S has meant a change to a shorter seasoning period for most offerings abroad, from the 90-day lock-up period preventing sales to United States persons, which previously prevailed, to a 40-day lock-up period.⁹²

Rule 15a-6, setting forth registration requirements for foreign broker-dealers, was also based on a territorial interpretation of the jurisdictional reach of the federal securities laws. In the past, the SEC had applied the EA to foreign financial institutions in their dealings with United States nationals even if such dealings had occurred entirely abroad if the Commission perceived such dealings as an evasion of United States regulations or a threat to United States markets.⁹³

In adopting rule 15a-6, the SEC reiterated its traditional view that the terms 'broker' and 'dealer' as defined in the EA,⁹⁴ include both domestic and foreign persons performing the activities described, and any use of United States jurisdictional means could trigger broker-dealer registration requirements. The SEC noted, however, that as a policy matter it had only applied these registration provisions 'territorially' to broker-dealers physically operating within the United States, and also to firms that from abroad solicit business from persons in the United States. Using this rationale, the SEC made rule 15a-6 an exemption from registration, rather than an exclusion from the statute.

Like regulation S, however, rule 15a-6 was an interpretative rule, setting forth a conception of SEC jurisdiction that was territorially based but captured solicitations of

⁹² Silverman, J. and Braverman, D. (1990), *Regulation S and Other New Measures Affecting the International Capital Markets*, Securities and Commission Regulations, Vol. 28, at 179 *et seq.*

⁹³ *United States v. Weisscredit Banca Commerciale E. D'Investimenti*, 325 F.Supp. 1384, 1391 [SDNY 1971].

⁹⁴ 15 USC sections 78c(a)(4), (5) (1997).

United States residents from overseas. Rule 15a-6 is less protective of United States institutional investors. It contains exemptions for non-direct contacts through unsolicited transactions and the distribution of research reports and also allows for direct contacts with specified institutional investors without intermediaries.⁹⁵

In addition, foreign broker-dealers may, without registration, contact or effect transactions with *SEC*-registered broker-dealers or banks, international organisations, foreign persons temporarily present in the United States and foreign agencies or branches of United States persons.

Currently, the *SEC* is reassessing its approach to both regulation S and rule 15a-6 and has pending proposals that would be a reversion to the *SEC*'s more aggressive jurisdictional claims of the 1960s and 1970s. The changes the *SEC* is contemplating under regulation S have been prompted in large part by the *SEC*'s belief that regulation S has been abused by domestic issuers.

According to the *SEC*, some issuers, affiliates and others involved in the distribution process are using regulations S as a guise for distributing securities into United States markets without the protections of registration under section 5 of the *SA*. Therefore, the *SEC* issued an interpretative release on problematic practices under regulation S and instituted a number of enforcement cases that involve domestic issuers.⁹⁶

Yet, the *SEC* did not limit either its proposed amendments to regulation S or its rationale for such changes to United States issuers abusing the regulation. Stating that:

⁹⁵ The class of institutions eligible for solicitation is smaller for direct than non-direct contacts. Foreign broker-dealers may contact United States institutional investors with the participation of a United States associated person, but may independently contact only United States institutional investors with over \$100 million of assets or assets under management.

⁹⁶ Securities Act Release No. 7190 (June 27th 1995), 60 Fed. Reg. 35663 (July 10th 1995); *In re GFL Ultra Fund Inc.*, Admin. Proc. Rel. No. 1284 (June 18th 1997); *In re Candies Inc.*, Securities Act Rel. No. 7263 (February 21st 1996); *SEC v. Softpoint Inc.*, Lit. Rel. No. 14480 (April 27th 1995); *United States v. Sung and Feher*, Lit. Rel. No. 14500 (May 15th 1995).

‘... although abusive practices involving the equity securities of foreign issuers are not as evident as with domestic issuers, there is equal potential for abuse where the principal trading market for those securities is in the United States.’⁹⁷

The SEC proposals would treat equity offerings by domestic issuers and equity offerings by foreign issuers whose principal equity securities market is in the United States the same, and subject offerings by them to the resale restrictions of rule 144.⁹⁸

This would be a big conceptual change. Instead of looking at a territorial limitation on the exercise of securities registration requirements, the SEC would be changing regulation S to a private placement exemption for domestic and certain foreign issuers. The SEC’s rationale for such a significant change is the:

‘increasing internationalisation of global securities markets, the growing use of the Internet for securities transactions, the further integration of the European and other markets through common currencies and regulatory treatments, and other recent and ongoing developments in the securities markets ...’

With regard to the registration of foreign broker-dealers, the SEC also is contemplating important conceptual changes. The rationale for these possible changes is that it is now possible for United States investors:

“to obtain real-time information about trading on foreign markets from a number of different sources and to enter and execute their orders on those markets electronically from the United States.”⁹⁹

97 *Securities Act* Rel. No. 7392 (February 20th 1997) at 5-6.

98 17 CFR Section 230.144 (1997).

99 Concept Release, Exchange Act Release No. 38672 (May 23rd 1997), 62 Fed. Reg. 30485, 30521 (June 4th 1997).

In view of technological developments in cross-border trading, the *SEC* has proposed three possible regulatory approaches:

- (1) reliance on a foreign market's home country regulator;
- (2) requiring all foreign markets to register as national securities exchanges or apply for an exemption; or
- (3) develop a tailored regulatory scheme to capture the entity that provides United States investors with ability to trade directly on foreign markets.¹⁰⁰

The *SEC* has never favoured mutual recognition, and it probably recognises that compelling foreign trading systems to register either as exchanges or broker-dealers would mean subjecting them to heavy day-to-day regulation of their businesses and affairs, now regulated in many cases by foreign regulators. Accordingly, the *SEC* proposed the creation of a new potential registration category – ‘*securities information processors*.’¹⁰¹ Although there is such a regulatory category in the *EA*,¹⁰² compelling only foreign trading systems to register is novel and controversial.

The common thread in the *SEC*'s reassessment of its territorial theory of securities and broker-dealer regulation seems to be fear of the internet. Both regulation S and rule 15a-6 depend to some extent on the principle of non-solicitation. Foreign issuers and intermediaries may escape *SEC* registration if they refrain from soliciting United States investors. On the internet, however, an issuer or financial institution does not solicit anyone in particular but simply advertises to the world. There are few cases interpreting internet jurisdiction, and so far none are securities cases.

¹⁰⁰ *Op. cit.*, at 30522.

¹⁰¹ *Supra*, note 99, at 30524-25.

¹⁰² 15 USC sections 78c(a)(22), 78k-1 (1997).

In one trademark infringement case, the court held that where an Italian publisher created an internet site, made it available to United States users and invited United States users to download images, the foreign publisher was distributing its publications in the United States.¹⁰³ In another trademark case, however, the Second Circuit held that creation of a web site in Missouri was not a tortious act in New York, subjecting the creator to personal jurisdiction, even if the web site caused injury to persons or property in New York.¹⁰⁴

If current developments require a rethinking of *SEC* jurisdiction, a number of approaches are logical and possible. *Fox* has suggested that the *SEC* limit its jurisdiction to United States issuers and allow foreign regulators to control foreign issuers, whether the regulatory or litigation question is registration or tort.¹⁰⁵ *Greene* and other practitioners have urged the *SEC* to move to a regime of mutual recognition.¹⁰⁶ *Salbu* has advocated harmonisation through statutes.¹⁰⁷

We have previously argued that mutual recognition is feasible only where some harmonisation exists, and the *SEC* is unlikely to accept mutual recognition without harmonization.¹⁰⁸ *Coffee* has pointed out that the internet does not require a radical

¹⁰³ *Playboy Enterprises Inc. v. Chuckleberry Publishing Inc.*, 939 F.Supp. 1032 (SDNY 1996).

¹⁰⁴ *Bensusan Restaurant Corp. v. Richard B. King*, 126 F3d 25 (2d Cir. September 10th 1997).

¹⁰⁵ Fox, A. (1997) '*Securities Disclosure in a Globalising Market: Who Should Regulate Whom*', Michigan Law Review, Vol. 95, at 2501 *et seq.* and Fox, A. (1992), '*Insider Trading In a Globalising Market: Who Should Regulate What?*', Law and Contemporary Problems, Vol. 55, at 263 *et seq.*

¹⁰⁶ See Greene, T., Curran, P. and Christman, C. (1997), '*Toward A Cohesive International Approach to Cross-Border Takeover Regulations*', University of Miami Law Review, Vol. 51, at 823 *et seq.*; see also Greene, T., Braverman, H. and Sperber, F. (1995), '*Hegemony or Deference: United States Disclosure Requirements in the International Capital Markets*', Business Lawyer, Vol. 50, at 413 *et seq.*

¹⁰⁷ Salbu, D. (1992), '*Regulation of Insider Trading in a Global Marketplace: A Uniform Statutory Approach*', Tulane Law Review, Vol. 66, at 837 *et seq.*

¹⁰⁸ Karmel, M. (1993), '*National Treatment, Harmonisation and Mutual Recognition*', IBA Capital Markets Forum Discussion Paper.

rethinking of existing legal concepts. Concepts like solicitation can be refined to take internet communications into account.¹⁰⁹

The territorial approach to jurisdiction has served the *SEC* and its constituents well and should not be lightly abandoned. It has made for relative certainty in structuring transactions, and it has avoided conflicts and tensions between the *SEC* and foreign regulators.

The *SEC* is a leader among the world's securities regulators and it is important to the future of regulation of the global capital markets that the *SEC* maintain respect and good relations with other regulators. While some current challenges involving the internet and other mechanisms in the evolving international markets may well be a cause for rethinking jurisdictional issues, the *SEC* should avoid taking approaches that will result in confrontations with foreign issuers, financial institutions, regulatory authorities and courts.

¹⁰⁹ Coffee, D. (1997), '*Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*' *Business Lawyer*, Vol. 52, at 1229 *et seq.*

7.4. *The Notion of Co-operation – The Weak Link*

The theoretical problem posed by the notion of extraterritoriality fundamentally highlights the problems caused when one state's political interests of independence, integrity and freedom are sought to be questioned by another. The result is, usually one of a political dilemma, with the odds stacked against the state seeking answers. One possible solution may be seen to exist in Treaties and *MOU's*, which are basically informal understandings between securities enforcement agencies and are primarily concerned with overcoming problems associated with secrecy and blocking laws.

Bank secrecy laws are a species of financial privacy laws whose purpose is to establish statutory obligations and duties applicable to the relationship between banker and his customer.¹¹⁰ Other species of financial secrecy laws include structural banking forms and impediments, and blocking statutes. Structural banking forms and impediments include use of anonymous (including numbered) accounts and accounts held under false names. The account holder signs an agreement with a personal bank agreeing to the conditions of the relationship and receives a number or pseudonym. These forms are intended to protect the customer by insulating bank employees who may be the target of inquiries (including bribes) from third parties seeking the identity of the account holder. Trusts and corporate structures also disguise financial transactions as a trust can include either an individual fiduciary holding assets in its own name or for a beneficiary. Combining a trust with a confidential account creates additional layers of anonymity.

¹¹⁰ Jones, A. (1991), '*Complusion over Comity: The United States' Assault on Foreign Bank Secrecy*', *Northwestern Journal of International Law and Business*, Vol. 12, at 454 *et seq.*. The most often-cited and inaccurate justification for bank secrecy laws is the belief that financial secrecy is somehow part of an individual's fundamental right of privacy; Gagnon, S. (1990), '*International Banking Secrecy: Developments in Europe Prompt New Approaches*', *Vanderbilt Journal of Transnational Law*, Vol. 23, at 657 *et seq.*

Statutes known as '*blocking laws*' are used to prohibit the disclosure, inspection or removal of documents located in one country in compliance with the orders of another country. Generally, there are two types of blocking laws. One prohibits production of documents or testimony before a foreign tribunal. The other prohibits substantive compliance with foreign governments' orders. While bank secrecy laws are designed to protect banking relationships, blocking laws are not uncommon in bank secrecy jurisdictions as they are used to impede legal discovery techniques. Most date back to the early 1980's when the *SEC* began to seek formal commitments by governments to co-operate in cross-border investigations, using the promise of reciprocity as consideration. Under the *Insider Trading and Securities Fraud Enforcement Act of 1988* a new section 21(a)(2) was enacted to the *SEA* which authorises the *SEC* to provide assistance to foreign securities authorities. The *SEC*, upon request of a foreign securities authority, may provide assistance if the requesting authority states it is conducting an investigation that it deems necessary to determine whether any person has violated any laws or rules relating to securities matters that the requesting authority administers or enforces. If necessary, the *SEC* may conduct its own investigation to collect information and evidence pertinent to the request for assistance.

Thirteen years ago a *MOU* was entered into between the *SEC* and the *DTI* in relation to securities. Its purpose was to set out the basis upon which the *SEC* and *DTI* could supplement information exchanges relating to on and off-market fraud. However, it is a shameful side of the United Kingdom's approach to the matter that the United Kingdom's authorities were among those European nations that displayed a stubborn resistance, often bordering on hostility, to implement meaningful and speedy change with regards to this area. Needless to say, quite apart from the fact that this results in a continued absence of effective international co-operation, this also is a waste of time and money. Some nations, according to regulators in the United States, erected petty obstacles to deadlock negotiations and succeed in dragging discussion levels to a dog-fight over alarmingly minor points. Even more serious is the damage to relations and the resultant fostering of hostility, mistrust and resentment.

Very little of course can be done to dissuade negotiators from adopting this type of narrow-minded attitude. All that seems possible is continued condemnation against such action. What might lessen the situation would be the involvement of regulators from the very beginning in the negotiation process as opposed to general civil servants, which seems to be the current situation. While their involvement is necessary at the outset, on the diplomatic level, their involvement should be dramatically curtailed as soon as the introductions are over.

The current approach to treaties and *MOU* is to specify its scope. Their purpose is to define the legal framework of enquiries covered. They should be as wide as possible; therefore it should cover not only statute and regulations, but also administrative requirements and good market practice. Then a liberal approach has to be taken to define what triggers a request. Suspicion should be enough; but most states favour good reason or evidence of a breach of a law or rule; it should not be necessary that civil, administrative or criminal proceedings be already in train before the foreign regulator may co-operate. The most negotiation will be with regard to the safeguarding against the unauthorised use of information by the receiving authority. This should not be a problem where the regulator undertakes to only disclose the information for the purpose of criminal, civil or administrative proceedings related, directly or indirectly to the general subject matter of the treaty. But it has caused problems in the past in United Kingdom negotiations. Provisions should also be made for the foreign authority to pursue enquiries or seek information within the other's territory. This is not possible under United Kingdom law as the *FSA '86* relates only to investment business in the United Kingdom. However where there is an overlap, and it is possible to construe the activity as being in the United Kingdom there is nothing in the *FSA '86* to stop the *DTI* or *Authority* from investigating a matter of foreign law, or allowing agencies of the foreign regulator from investigating a matter jointly with the United Kingdom authorities.

Most treaties and *MOU*'s create the opportunity for the requesting state to refuse co-operation on the grounds of local public interest. This is in fact rarely used and

creates no harm by its presence. The only use it seems to serve is to allow for the interests of national security to be catered for. Obviously each *MOU* will need to provide for the possibility of amendment in the light of experience.

The principal area of difficulty in the negotiation of *MOU's* seems to relate to territoriality and confidentiality. With regards to the former parties may disagree as to the scope of their respective territorial jurisdiction. This has not arisen in the context of actual practice in the field of securities co-operation; when it has dual jurisdiction has not been a problem or has been resolved by consultation. However, there are some problems, albeit relatively minor, caused by the issue of confidentiality, especially if there is a suspicion that information may leak to the tax authorities of a requesting state.

7.5. Summary

It has been noted in this chapter that the greatest and probably most frustrating element of any financial crime investigation is where the criminal has sought to utilise the element of another, usually uncooperative, jurisdiction to mask his evidential trail. This in the past would have put an end to such an investigation. Moreover, in the last decade such activities have become even more of a threat given the influence the internet and organised crime factions have had in this area. Yet, it has also been a time of growth for both regulators and investigators in their stark acknowledgement of the problems faced by this facet and understanding of the need for co-operation.

The use of *MOU's* and treaties have openly been grasped by many as the way forward. While both the United Kingdom and United States have also actively sought to reduce the perplexing problems associated with the extraterritorial nature of financial crime via a number of different legal ways unofficial channels of co-operation have proven to be the most effective in tracking down those who wish to remain anonymous. It is hoped that in the future such channels can be extended further so that eventually there will be little or no room for the criminal to manoeuvre in. However, this seems unlikely given the financial impetus that surrounds crimes. Weaker jurisdictions will undoubtedly bow to the wishes of a wealthy businessman in the interests of their own gain. So what can be done to reduce this? At present it seems that many alliances are built on good will and the interchanged of valued information. It seems logical to assume then that the latter rather than the former issue may play a part ultimately in lifting the lid of secrecy with less co-operative jurisdictions although the information provided must be more beneficial than the amount of financial gain being sacrificed.

Chapter Eight

Drawing the Strands Together – General Conclusion

The aim of this research was to evaluate the methods used both in the United Kingdom and United States to assess whether any lessons could be learnt from both regarding the regulation, investigation and deterrence of insider dealing and market manipulation. It sought to analyse the various methods adopted by comparing, where relevant, legal, procedural and policy considerations in an attempt to clarify the weaknesses and strengths of each jurisdiction.

During the last five years the United Kingdom has actively sought more than any other time to recognise and develop rules and mechanisms by which to deter the aforementioned activities. Whether they will be successful is a matter of conjecture at present, as they have not been fully implemented. Yet one thing stands out more than any new changes in the law. This relates to the impetus now given to the effect such crimes have on financial markets. Whether this is due to the change in government is debatable but it is a welcome addition to the powers, albeit limited compared to the United States, which already exist. However that said, by comparison to the United States the United Kingdom is still wilfully lacking a driving force that has helped the former jurisdiction become one of the most successful countries in investigating, prosecuting and deterring insider dealing and market manipulative activities.

The United States has long recognised the problems associated with financial crime. Jurisprudentially speaking, it has a long history of regulating financial criminals via its use of the vast array of laws at its disposal. Yet, it too has had problems in recent times, notably during the 1980's, with the unwanted growth of insider dealing. Its overall attitude to deal with such problems head-on, with the implementation of specific legislation to attack the problem is to be commended.

With any sought of activity that generates vast amounts of capital it is common to find that individuals with less than honourable and genuine motives will be attracted. Insider dealing and market manipulation are two such activities. It is not surprising then to find that when the value of markets grow such unwanted activities also follow. However, in the last five years a growing trend in exploiting such markets from the confines of cyberspace has presented many regulators with problems that they may not have thought existed. While the United States has sought to embrace new ways of dealing with this added dimension the United Kingdom, in comparison, is still far behind. Added to this equation is the fact that many organised crime syndicates now see financial markets as a successful way of laundering illegal profits with little chance of being caught.

In chapter one of this thesis it was noted that insider dealing and market manipulation are not new crimes. Both practices have been documented to exist many centuries ago. Indeed, it has been argued that at times both where acceptable market practices. Given the findings made in the appendix relating to how today's practitioners in the United Kingdom view this it can be observed that this view still exists for many. It is not surprising therefore that so few cases of insiders really feel the full extent of the sanctions that should be imposed upon them.

Chapter two examined how both jurisdictions regulated financial crime. By comparison to the United States it was observed that the United Kingdom has now embraced a centralised form, albeit not as well defined in role, of regulation. The *Authority* cannot be viewed as an equivalent to the *SEC* but must be seen a step in the right direction. This chapter also acknowledged that the belief in investor confidence played a paramount role in determining why financial crime should be regulated.

Chapter three acknowledged that both jurisdictions used differing methods of regulation in deterring and prosecuting insider dealing. While the United States has long advocated the use of case law to define the parameters its legislation has in determining a potential insiders liability the United Kingdom, along with many other European states has sought to follow, albeit loosely in parts, the *European Directive on Insider Dealing* brought about in 1989. The United Kingdom has also been a strong advocate of the criminal law while the United States has long favoured using

the civil law in the vast majority of cases. The Criminal law is only used in severe cases and is dealt with the Department of Justice. Such a separation of powers and the general kudos enveloped by the United States has helped them immensely in effectively regulating this practice.

Chapter four specifically examined how market manipulation and misleading practices were regulated. It highlighted the problems associated with the ambiguous nature of manipulation, in that there was sometimes a fundamental blurring between activities that may or may not be illegal. The United Kingdom was seen to long favour the use of the *FSA '86* in dealing with such matters whilst the United States has followed similar procedures to that developed alongside insider dealing. It was concluded that the United Kingdoms position needs drastic amendment in order to gain more credit and enhance its ability to ensnare manipulators.

Chapter five sought to examine the differences and problems faced by regulators both here and in the United States. The general findings related to the fact that insider dealing and market manipulation were extremely difficult activities to spot, especially on markets where trading is volatile and encourages complicated transactions to occur. Derivative trading and markets are prime examples of this. Interestingly, in this chapter the effect *market abuse* and its regulation were examined. What was concluded was that although it created an additional layer of liability for market players it was not defined enough and consequently unless amended may ensnare an innocent individual or companies embarking on some form of innovative but legal procedure or trading technique.

Chapter six examined the problems associated with the process of prosecution of financial fraud. It examined the main problems linked with the public perception of financial crime coupled with matters relating to the suitability of juries and sentencing. The public perception of financial criminals exposed a general belief that such criminals were not as heinous as murders or rapists due to the anonymity of the damage committed by them. The notion of a '*victimless crime*' as examined in chapter two seemed to be the biggest stumbling block in convincing juries that such criminals were indeed similar. That said, it was perceived that juries played an important part in the prosecution process and that in no way did this detract from their

overall ability to decide the guilt or innocence of the defendant. The role of sentencing was also critically examined to determine the most suitable form of punishment. Adverse publicity and criminal sanctioning seemed to be the most effective deterrence.

The notion of extraterritoriality has long caused problems for regulators and investigators of financial crime whether they are based in the United Kingdom or United States. Yet in stark comparison with one another it was noted that the latter jurisdiction has more actively sought to utilise its own domestic law in an extraterritorial capacity than the former. However, the use of unofficial treaties and *MOU's* were deemed to be the most useful tools in the fight against the element of jurisdiction.

To summarise this conclusion the following findings have been made:

- Insider dealing and market manipulative practices are neither new nor perceived threats to financial markets both in the past and present by many.
- The true extent of the penetration of such activities will never be known given the complexities that exist surrounding financial markets.
- Such activities have indeed shaped both jurisdictional attitudes towards how such markets should be regulated.
- A divide exists between how both the United Kingdom and United States perceive the effectiveness and usefulness of both the civil and criminal law.
- There are stark constitutional differences between both jurisdictions that have dramatically shaped their views on the regulation of financial fraud.

- The complex nature of secondary financial markets, the use of internet trading and fraud and the threat they possess regarding being exploited by financial criminals is only now being realised.
- The notion of extraterritoriality and the problems associated with it when carrying out investigations has been recognised but effective procedures are yet to be fully formed.

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